Argent
Wealth Management, LLC

Employee Stock Ownership

August 2023

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Argent Overview

Differentiation:

Deep knowledge and practice of Tax, Estate Planning & Investments under one roof.

AUM ~$2 billion

Founded 1992

Endowment Approach to Investments

Strategic Partnership with Hightower Advisors LLC

Ranked #2 in Barron's 2022 List of Top RIA Firms*

*Compensation was paid for the ability to use the Barron's Top 100 RIA Firms logo in marketing materials

Independent fee-only advisor

- Fiduciary
- No conflicts of interest/Total alignment with our clients

Breadth and depth across full spectrum of wealth management services

- *Investments*
- *Financial Planning*
- *Estate Planning*
- *Tax*

Content Overview

Stock Units & Options

- RSUs
- ISOs
  - Qualifying Dispositions
  - AMT
- NSOs
  - 83(b) Elections

Ownership Plans

- ESPP
  - Qualifying Dispositions
- ESOP
  - 1042 Exchanges
  - NUA

Summary

	RSU	ISO (QD)	NSO	ESPP (QD)	ESOP (NUA)
Pre-ownership period	Vesting period begins No taxable event	Grant Date No taxable event	Grant Date No taxable event	Offering period begins No taxable event	Contribution period begins No taxable event
Stock comes into possession	Units Vest FMV is W2 income	Option is exercised No taxable event (except AMT)	Option is exercised OI on Bargain Element	Stock is purchased at discount No taxable event	Stock is distributed from ESOP > moved to taxable acct OI on ER conts.
Stock is sold	Units are sold Typical CG treatment	Stock is sold CG on total appreciation above exercise price	Stock is sold CG on appreciation since exercise	Stock is sold OI: FMVoffer minus Purchase Price CG: Sale Price minus Purchase Price	Stock is sold LTCG on appreciation (STCG on addt' app. if sold <1 yr)
Additional Considerations	n/a	Qualified Dispositions AMT	83b Elections to pay O.I. early	Qualified Dispositions	NUA Transfers 1042 Exchanges and QRP

Stock Units and Options

Restricted Stock Units (RSUs)

Restricted

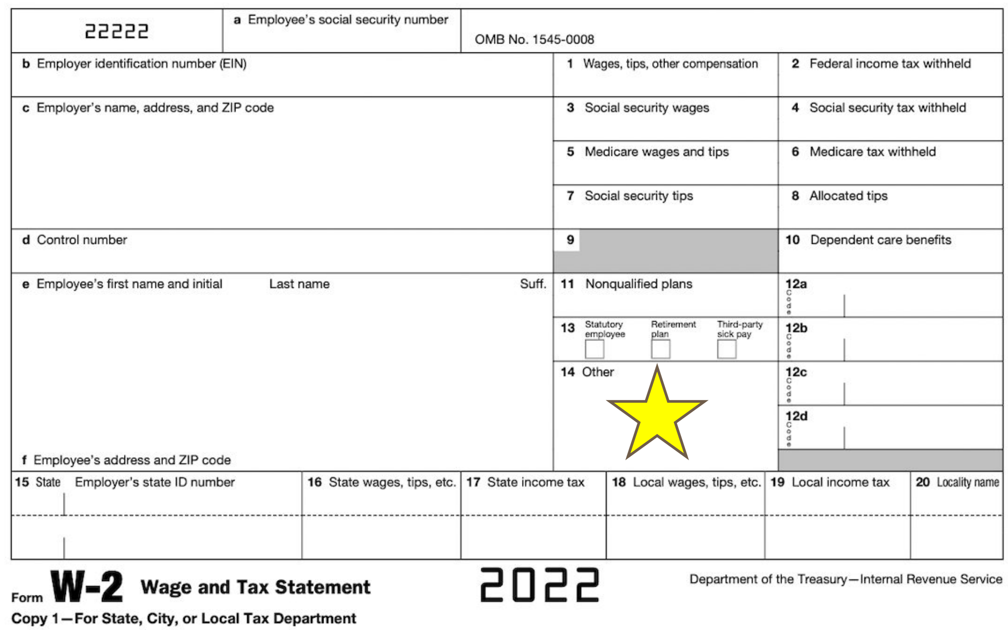
- The employee receiving the shares cannot sell them until they are vested
- Goal Targets / Gradual / Cliff Vesting

Stock

- The FMV of stock (typically at vesting) is taxable compensation on W2
- Once shares are owned, selling the shares follows typical capital gain treatment (shown on 1099-B)

Units

- RSUs are actual ownership of the shares, not options to purchase them

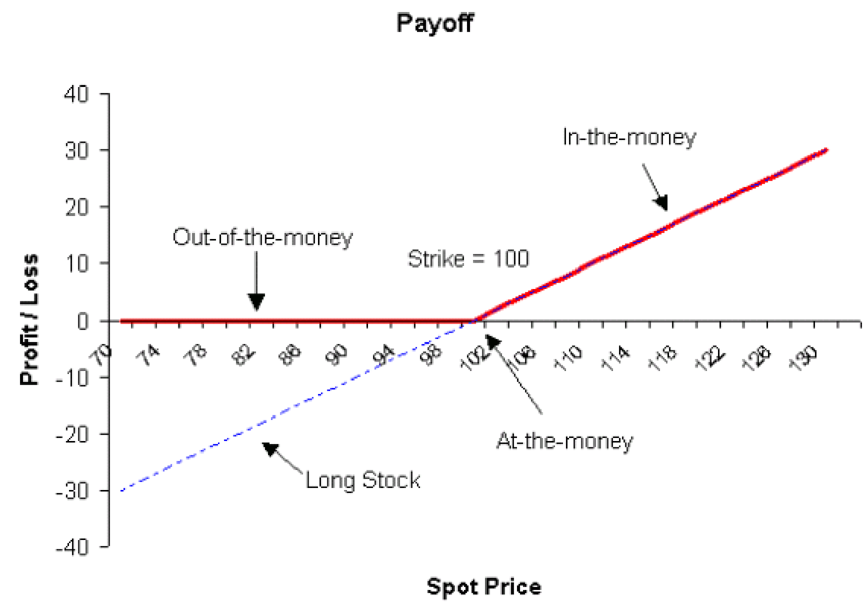

22222
a Employee's social security number
OMB No. 1545-0008
b Employer identification number (EIN)
1 Wages, tips, other compensation
2 Federal income tax withheld
c Employer's name, address, and ZIP code
3 Social security wages
4 Social security tax withheld
5 Medicare wages and tips
6 Medicare tax withheld
7 Social security tips
8 Allocated tips
d Control number
9
10 Dependent care benefits
e Employee's first name and initial
Last name
Suff.
11 Nonqualified plans
12a
13 Statutory employee
Retirement plan
Third-party sick pay
12b
14 Other
12c
12d
f Employee's address and ZIP code
15 State
Employer's state ID number
16 State wages, tips, etc.
17 State income tax
18 Local wages, tips, etc.
19 Local income tax
20 Locality name
Form W-2 Wage and Tax Statement
2022
Department of the Treasury—Internal Revenue Service
Copy 1—For State, City, or Local Tax Department

What is an Option?

An option is the right, not the obligation, to buy/sell a share of stock for a specified price

Most employee stock options are like "Call Options"

- *If the price of the stock **is higher** than the "strike price", the option **is exercised** and the owner benefits by **buying at a discount***
  - *Option is "in the money"*
- *If the price of the stock **is lower** than the "strike price", the option **goes unexercised**, and the owner **has no obligation to buy the stock at a premium***
  - *Option is "out of the money"*



Source: Finance Train on 8/23/2023

Black-Scholes Model

Formula

$$C(S,t) = N(d_1)S - N(d_2)Ke^{-rT}$$

$$d_1 = \frac{ln\left(\frac{S}{K}\right) + \left(r + \frac{\sigma^2}{2}\right)T}{\sigma\sqrt{T}}$$

$$d_2 = d_1 - \sigma\sqrt{T}$$

$C(S,t)$	(call option price)
$N()$	(cumulative distribution function)
$T = (T_1 - t)$	(time left til maturity (in years))
S	(stock price)
K	(strike price)
r	(risk free rate)
σ	(volatility)

WallStreetMojo

Source: WallStreetMojo on 8/23/2023

Incentive Stock Options (ISOs)

ISOs give employees the option to buy shares of stock

- ISOs are also known as qualified or statutory stock options
- ISOs are given to key employees as both a retention and motivation tool
- The strike price of an ISO must be at least the FMV of the stock at the time it is granted

Taxation

Grant Date *– the day the company gives the employee the option to buy stock at a later date*

- No taxable event

Exercise Date *– the day the employee exercises the option and buys the shares at a discounted price*

- This "bargain element" (the amount of discount) is **NOT taxable yet**!
  - *[1]But it is an AMT add-back item*

Sale Date *– the day the employee sells the stock they bought on the exercise date*

- The total gain on the stock above the exercise price is taxed at **CG rates**

[1]By including your ISO exercise income for AMT purposes in your tax return, you increase your basis of the shares within the AMT realm. This does NOT affect your basis for regular taxes. The result is that you will have two different bases, one for the standard tax calculation and one for AMT

Incentive Stock Options (ISOs) cont.

But with great power comes great responsibility…

To obtain the favorable tax treatment, the stock must be sold through a qualified disposition. This means it does not violate any of the below conditions.

If the disposition is deemed disqualified, the ISO is treated as a Nonqualified Stock Option for tax purposes.

Qualifying Dispositions

1. *The stock must be sold **at least 2 years after** the date it was **granted** to the employee*
2. *The stock must be sold **at least 1 year after** the date it was **exercised** by the employee*
3. *The stock must be part of the **first $100,000** that vested in that calendar year (based on the value at **grant date**)*
4. *The option must be held by the employee, meaning ISOs cannot be gifted before exercise and retain ISO tax treatment*

1 year after Exercise: "E"

2 years after Grant: "GG"

Incentive Stock Options (ISOs) cont.

ISO Qualified Disposition Example:

Matt, aged 40, is granted ISOs from his company. The ISO grants Matt the option to buy it for $10/share.

One year later, Matt exercises his options to buy the stock for $10/share, and the value of stock has climbed to $50.

The following year, Matt sells his shares at its new market price of $65/share

Be advised, there are tax implications not covered in this presentation when the price of the stock declines instead of appreciates. This will be true of all examples covered.

Taxation:

Grant Date *– Matt is 40*

- No taxable event

Exercise Date *– Matt is now 41*

- Matt bought the stock for $40 less than it is worth per share. **This is not taxable to him yet and will not be ordinary income!**
  - *But it is an AMT add-back item*

Sale Date *– Matt is now 42*

- Matt sold the stock for $65/share and his basis is $10/share. LTCG will be applied on the $55 of gain
- Matt has paid $10 for stock that is worth $65, deferred taxes, and is only paying capital gains tax instead of ordinary income on the bargain element

Test*– Matt waited 2 years from the grant date and one year from the exercise date, resulting in a qualified disposition*

Nonqualified Stock Options (NSOs/NQSOs)

NSOs are similar to ISOs in that they allow the employee to buy stock at a discounted price, but they have less favorable tax treatment than ISOs

Taxation

Grant Date – *the day the company gives the employee the option to buy discounted stock at a later date*

- **Still not a taxable event**

Exercise Date – *the day the employee exercises the option and buys the shares at a discounted price*

- [1]The difference between the FMV at exercise and the exercise price (bargain element) **is taxable now as ordinary income**

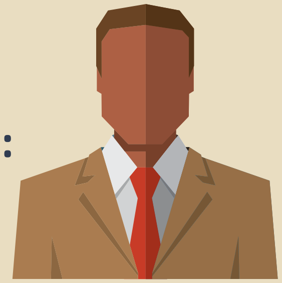
Sale Date – *the day the employee sells the stock they bought on the exercise date*

- The gain on the stock since purchase on the exercise date is **taxed at capital gains rates.** The holding period is based on time since exercise

[1]*This is a disadvantage compared to ISOs because ordinary income tax rates are higher than long-term capital gain tax rates*

Nonqualified Stock Options (NSOs/NQSOs) cont.

NSO Disposition Example:



Jeff, aged 40, is granted NSOs from his company. The NSO gives Jeff the option to buy it for $10/share.

One year later, Jeff exercises his options to buy the stock for $10/share, and the value of stock has climbed to $50.

The following year, Jeff sells his shares at its new market price of $65/share

Taxation:

Grant Date *– Jeff is 40*

- No taxable event

Exercise Date *– Jeff is now 41*

- Jeff bought the stock for $40 less than it is worth per share. **This $40/share is taxable as ordinary income**
    - *There is no AMT associated like with ISOs*

Sale Date *– Jeff is now 42*

- Jeff sold the stock for $65/share and his basis is $50/share. LTCG will be applied on the $15 of gain
- Jeff has paid $10 for stock that is worth $65 but had to pay ordinary income tax along the way. He now pays capital gains tax on $15 of gain

Test*– There are no tests to pass. Jeff could have exercised his options immediately and sold them as soon as he received the stock. The only penalty for doing so would be that he now must pay STCG rates instead of LTCG rates*

Nonqualified Stock Options (NSOs/NQSOs) cont.

Section 83(b) Elections

Section 83(b) allows someone to pay the ordinary income tax on their stock award **at Grant Date instead of the Exercise Date**

This is pivotal choice that can save you a significant amount of taxes if executed under an advantageous fact pattern

Why would someone choose to pay taxes early? Don’t we want to want to defer taxes as late as possible?

Let’s look at an example…

Nonqualified Stock Options (NSOs/NQSOs) cont.

83(b) Election Example:

*Jeff, aged 40, is granted NSOs from his company. Despite the stock price being **$25/share**, the NSO gives Jeff the option to buy it for **$10/share.***

Jeff makes an 83(b) election to pay ordinary income tax on the spread now.

*The stock vests/can be exercised 5 years later when the price per share is **$80/share***

*7 years from today, Jeff sells his shares at its new market price of **$100/share***

Taxation:

Grant Date *– Jeff is 40*

- Jeff elects 83(b) and pays ordinary income tax on $15 ($25 - $10) and now has a basis of $25.

Vesting/Exercise Date *– Jeff is 45*

- No tax happens here as Jeff has already paid ordinary income prior to receipt of his stock

Sale Date *– Jeff is now 47*

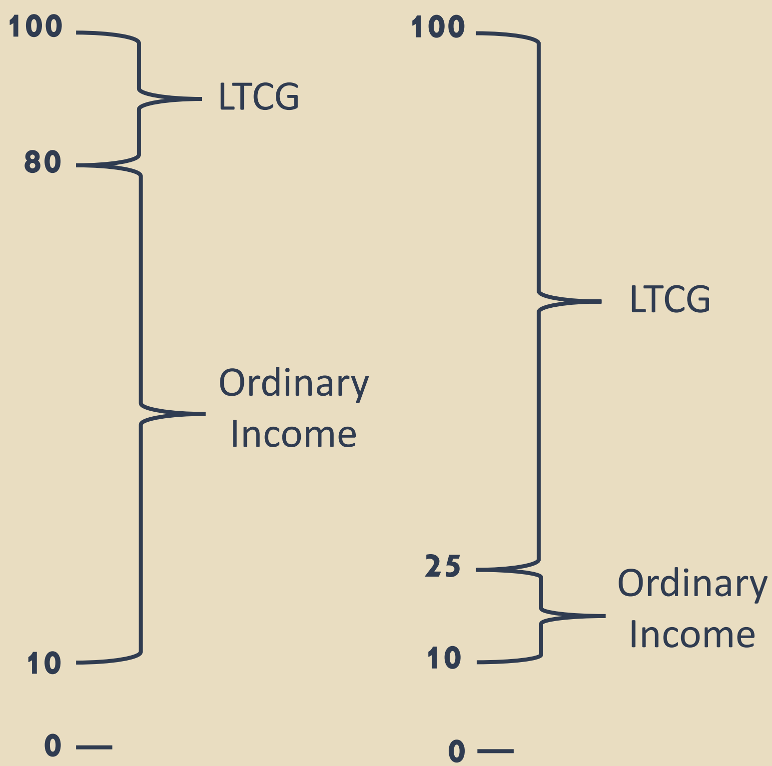
- Jeff sold the stock for $100/share and his basis is $25/share. LTCG will be applied on the $75 of gain
- Had Jeff not elected 83(b), he would have paid ordinary income on $70 ($80 - $10) instead of $15, and only would get LTCG treatment on $20 ($100 - $80) instead of $75.

Because the initial spread was small and the stock price was expected to increase significantly, paying the ordinary income on the small difference in price at the grant date allowed the majority of appreciation to be taxed at LTCG

Nonqualified Stock Options (NSOs/NQSOs) cont.

Here is a breakdown of the tax savings from the previous example:

No Election **83(b) Election**



Assuming Jeff has:
1,000 shares, 37% ordinary rate, 20% LTCG rate

	Tax with No Election	Tax using 83(b) Election
Proceeds	100,000.00	100,000.00
Ordinary Income Tax	(25,900.00)	(5,550.00)
LTCG Tax	(4,000.00)	(15,000.00)
Net Income	70,100.00	79,450.00
Effective Rate	29.90%	20.55%
Tax Savings	-	**9,350.00**

For Illustrative Purposes Only

Stock Ownership Plans

The Who and Why of Stock Plans

What kinds of companies offer stock ownership plans?

- **Non-closely held companies**
  Public or Private
- **Mid Market**
  10M – 1B in revenue
- **S and C Corps**
  Not partnerships

Why would a company want to offer a stock ownership plan?

1. *Employee Retention*
2. *Broaden market for business succession*
3. *Sense of Ownership*
4. *Tax-Advantaged Transfer Method*

Employee Stock Purchase Plans *(ESPP)*

ESPPs

*A plan in which employees **purchase** employer stock **with after-tax money** at a **discounted price.*** (§423 plan)

1. Offering Period – this is the period in which employees elect to contribute after-tax money from each paycheck into an account ($25k max/yr). Funds accumulate here during the offering period
   - 3-year max offering period
   - You can withdraw these funds penalty-free at any time
2. Purchase Date – after funds have accumulated for some time, the employee uses these contributions to purchase stock at a discounted price
   - Max 15% discount on FMV at offering
3. Ownership Period
   - You can sell your shares right away, or hold onto them for LTCG treatment

Taxation of ESPPs

- Tax is only due at the sale date
  - There are both ordinary income and capital gain components
- ESPPs follow the same qualifying disposition **(“EGG”)** rules as ISOs
  - Qualifying dispositions allow the **lesser** of the **stock price at offering** and the **stock price at purchase** to be used in calculating the ordinary income component

Cautionary Tale: Do not let the tax tail wag the dog! The primary factor should always be the outlook of the company and not tax savings

Employee Stock Purchase Plans (ESPP) cont.

ESPP Qualified Disposition Example:

Lynn, aged 30, starts contributing to her company's ESPP. At the beginning of this offering period, the stock is worth $20/share

One year later, Lynn purchases shares of stock for $17/share (a 15% discount from the offering value). However, the stock has gone up in price to $25/share by this point

The following year, Lynn sells her shares at its new market price of $50/share

Taxation:

***Offering Date**– Lynn is 30*

- No taxable event

***Purchase Date**– Lynn is 31*

- Lynn bought the stock for $17, despite it being worth $25. This is not taxable to Lynn yet

***Sale Date** –Lynn is now 32*

- Lynn sold the stock for $50/share, for total appreciation of $33. But how is this appreciation taxed?
- **Test**– Lynn waited 2 years from the offering date and one year from the purchase date, **resulting in a qualified disposition**
  - Therefore, only $3 is ordinary income (20 – 17), and $30 is LTCG (50 – 20)
  - Had this been a Disqualified Disposition, $8 would have been ordinary income (25 – 17) and $25 would have been capital gain (50 – 25)

Employee Stock Ownership Plans (ESOP)

ESOPs

*A **qualified retirement** plan (profit sharing or money purchase) in which employees **are awarded** employer stock as a stock bonus*

- Funded by employ**<u>er</u>** (not employee) with pre-tax dollars
- In many cases, the shares are purchased back from the employee by the ESOP trust when the employee wants to sell

Taxation of ESOPs

Contribution Period: Employer contributes to the plan while you work for the company

- These **contributions are not taxable to you** in the same way your employer match in your 401-k is not taxable

At Retirement (or other qualifying event)

- The **basis** the company contributed into your account is taxed as **ordinary income**
- The **net unrealized appreciation (NUA)** of the stock over your working life is taxed as **LTCG** when the stock is sold
  - **Whereas typical retirement plan distributions come out entirely as ordinary income**

Employee Stock Ownership Plans (ESOP) cont.

ESOP Qualified NUA Example:

Joe, aged 30, participates in his company's ESOP. Over the course of his career, the company contributes $200,000 worth of employer stock into the plan.

At age 65, Joe retires. The value of the stock has risen to $800,000. He takes a one-time distribution of stock and moves it into his taxable account

At this point Joe is free to diversify out of employer stock and into a balanced portfolio that matches his risk tolerance

Taxation:

Contribution Period– *Joe is 30-65*

- No taxable event

Retirement Date– *Joe is 65*

- Of the $800,000 distribution:
  - The $200,000 of contributions are taxed as ordinary income
  - The remaining $600,000 of NUA is taxed as LTCG when the stock is sold, producing significant tax savings
- With a typical 401(k), the entire $800,000 would be treated as ordinary income

Employee Stock Ownership Plans (ESOP) cont.

How to successfully complete an NUA transfer

If the following steps are not taken, the entire distribution is taxed at ordinary income instead of getting the favorable LTCG tax treatment

1. **The entire lump sum from the ESOP must be moved into a taxable non-retirement account**
2. **Employer stock must be moved in-kind and not liquidated first**
3. **Must have reached a qualifying event**
    a. Reaching age 59.5
    b. Retirement after 59.5
    c. Separation of service
    d. Total disability
    e. Death

Implication 1*: you cannot retire at 65 and decide at age 80 that you want to complete your NUA transfer (as there would not have been a qualifying event at 80)*

Implication 2*: you cannot roll these funds into another retirement account*

Net Unrealized Appreciation (NUA)

Utilizing NUA tax treatment is <u>not always</u> favorable

NUA utilization tends to be beneficial only if:

1. Your company stock has appreciated greatly above the contribution amount
   - *Meaning you have a large NUA*
2. You are in a high tax rate
   a. *As the lower the tax rate, the more the savings between Ordinary Income and LTCG is diminished*
   b. *But ordinarily, if you are in retirement and no longer have income (and your distribution is small), you may already be in a lower tax bracket than typical*

Alternatively, you could roll all (<u>or some</u>) of your ESOP into another retirement account (e.g., IRA)

This allows you to:

1. Be strategic about when you want to take your ordinary income
2. Defer taxes until Required Minimum Distributions kick in
3. Cherry-pick high basis shares to roll over and low basis shares to get NUA treatment

1042 Exchanges

If, at the time of stock sale, the company is classified as a **C-Corp**, you may elect to use the proceeds of ESOP stock to invest in **Qualified Replacement Property (QRP).** This does not defer the ordinary income, but the **capital gain is deferred indefinitely** until the sale of the QRP.

Only available for C-Corps

S-Corps would need to convert to C-Corps for this to work

*Although this is subject to change in 2027 via SECURE 2.0

The proceeds must be reinvested in Qualified Replacement Property

This **includes** securities issued by US operating companies (**stocks and bonds**)

But specifically **excludes** CDs, Mutual Funds, ETFs, REITs

The QRP must be invested in within 12 months of sale

As a result, the proceeds must be available to you and not given as a personal note

ESPPs vs. ESOPs Cheat Sheet

The **3 main differences** between these two types of ownership plans:

Whether or not the employee pays for the shares

- ESPPs allow for employee **purchase** and is **post-tax**
- ESOPs hold shares of stock **given** as a benefit and is **pre-tax**

When the employee receives and can sell the shares

- ESPPs allow for sale at any time
- ESOPs require employees to hold shares until retirement

Tax Treatment

- ESPPs have qualified disposition rules
- ESOPs have tax-advantaged techniques available to them (NUA / 1042)

Review / Appendix

Biography

Tony Maenhout Financial Advisor

Tony joined Argent Wealth Management in January of 2021 after spending 2 years with Willis Towers Watson as an actuarial retirement consultant. In his role as an Associate Advisor, Tony assists senior advisors in constructing financial plans, performing in-depth analysis on client portfolios, and is dedicated to tax preparation and estate planning.

Tony graduated summa cum laude from Bentley University in 2019 where he earned a Bachelor of Science in both Actuarial Science and Business Administration. He has his Series 65 License and passed the Certified Financial Planning (CFP®) exam in 2022.

Raised in Marlborough, Massachusetts, Tony currently lives in South Boston. In his spare time, Tony loves to make pizzas, watch soccer and is an annual runner of the Boston Marathon.

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Disclosures

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