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Employee Stock Purchase Plans And Restricted Stock Units: A Deep Dive

By Komal Motwani (https://advisornews.com/author/komal-motwani)

In the recent years, employees have become more knowledgeable about their compensation options. A straightforward salary no longer works. Medical benefits and other perks too are dated. The new asking price is stock benefits.

We have seen companies offering restricted stock units and employee stock purchase plans to their employees either as a bonus and retirement plan, or part of equity compensation benefits. These are not new terms but the concept maybe new to some people. Let's take a deeper dive and understand the basic difference between ESPPs and RSUs.

An employer stock purchase plan is a benefit that may be offered by a publicly traded company to its employees to purchase company's stocks at a discounted price (usually up to 15% discount off the fair market value). Employees can choose to participate during an open enrollment or offering period. The IRS allows employees to contribute a maximum of $25,000 each year, although each company may have their own internal caps. Employees contribute through payroll deductions (after-tax income). Contributions are withheld from an employee's paycheck. The deducted funds are not used to purchase stocks immediately rather are accumulated by the employer and purchased on specific purchase dates (typically at the end of six months).

ESPPs have a "look-back" provision. I will explain this provision with an example. Say you decide to enroll in a plan when the stock price is $50; six months later, the market price of the stock increases to $60. You are able to purchase the shares at $50 minus 15%, so your purchase price is $42.50 (assuming company is offering a 15% discount). Now what happens if, six months later, the stock price falls to $40? You are able to buy the shares at $34 – a 15% discount to the current $40 market price. An employee can apply their employer's discount to the lower of the two, current market value or the price on the first day of the offering period. To make the matters more complex, ESPPs can be qualified or nonqualified plans. Most ESPPs are qualified and have favorable tax treatment.

RSUs are cousins of ESPPs. Just as cousins in a family are diverse, RSUs are structured differently. Companies (public and private) often use this vehicle to grant ownership to the employees via vesting schedule (hence the term "restricted"). This is a way of incentivizing employees to stay with the firm and, in turn, help the firm to perform at its best. The employees are awarded shares over a period of time. A common vesting schedule is a grant with one-year cliff that means vesting starts after one year (usually two to five years). Every year (from the second year onwards), 25% of the awarded stocks are vested and transferred to the employee's brokerage account.

RSUs are another type of equity compensation commonly seen in start-ups or technology-innovation driven companies. Unlike, ESPPs you cannot enroll for the benefit. Instead, RSUs are granted by the company, typically upon hire or being promoted. If an employee leaves the company before all their RSUs are vested, then they must forfeit the unvested units. RSUs are taxed as ordinary income as soon as the shares are vested and delivered to the employees. Taxable income will include market value of the shares at vesting and are treated as compensation. Once vested, if the employee sells the shares (after one year), the gains are subject to long-term capital gains.

To understand the taxation on ESPPs and RSUs, please consult an accountant.

Komal Motwani, CFP, is a senior investment analyst with Yanni & Associates Investment Advisors in Wexford, Pa. She has more than 10 years of experience in the field of investments and financial planning. She may be contacted at komal.motwani@innfeedback.com (mailto:komal.motwani@innfeedback.com).