

The ESPP and Equity Comp Review Checklist

7 Questions Every Equity-Compensated Employee Should Be Able to Answer

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Why this checklist exists

Equity compensation creates more tax surprises per dollar than salary does. A salary paycheck is taxed predictably and withheld at roughly the right rate. Vesting events, option exercises, and discounted stock purchases are taxed under different rules, withheld at different rates, reported on different forms, and timed in ways that often produce a larger bill than expected.

For someone earning \$300,000 or more with a meaningful equity comp component, the planning decisions involve two pressures pulling against each other. One is the tax bill, which can be reduced through holding period rules and timing. The other is the risk of holding a large position in one company's stock, which compounds quietly the longer the position is held. Most of the decisions in this checklist involve weighing those two pressures, and the right answer is genuinely different for different people.

This checklist is not a financial plan. It is seven questions that, once you can answer them, will put you in a much better position to make the decisions on your own terms.

This document is for educational purposes only and does not constitute investment, tax, or legal advice. Every situation is different.

SECTION 1

Employee Stock Purchase Plan (ESPP)

1. What is the discount in my plan, and does it have a lookback?

An Employee Stock Purchase Plan (ESPP) lets you buy shares of your employer through payroll deductions, typically at a discount of up to 15 percent. The discount is the actual economic benefit and it is real money. A 15 percent discount on \$25,000 of purchases per year is \$3,750 of value before any change in the stock price.

Many plans add a feature called a lookback. With a lookback, the purchase price is calculated using the lower of the share price at the start of the offering period or the share price at the purchase date. In a rising market, this can produce an effective discount well above the stated 15 percent. A stock that runs from \$40 at the start of an offering period to \$60 at purchase, with a lookback and a 15 percent discount, gets purchased at \$34, an effective discount of about 43 percent off the purchase-date price.

The plan's discount percentage and the existence of a lookback are the two terms that drive the entire economic case for participating.

2. Am I selling immediately, or am I holding for qualifying disposition treatment?

Selling shortly after purchase locks in the discount as ordinary income and removes the position from your portfolio. Holding the shares long enough to meet two specific thresholds (more than two years from the offering date and more than one year from the purchase date) qualifies the sale for what is called a qualifying disposition, which moves a larger portion of the gain into long-term capital gains rates rather than ordinary income rates. For someone in the 35 percent federal bracket, the difference between ordinary income treatment and long-term capital gains can be 15 to 20 percentage points on the appreciation portion of the sale.

There is real tension in this decision. Holding longer reduces the tax rate on appreciation, but it also keeps a larger position in a single stock that the holder is already economically tied to through their job. For someone whose salary, bonus, and other equity grants are all from the same company, every additional dollar held in that stock is a dollar of concentrated risk. The cost of staying concentrated may not show up until the company has a bad year, and at that point both the salary and the stock are exposed.

The factors that matter in this decision are personal: how much of your net worth is already in employer stock, what your view is on the company independent of being an employee, and how stable your underlying cash flow is. There is no general answer.

Callout: The Broker Basis Trap

When you eventually sell ESPP shares, the broker who held them will send you Form 1099-B. In most cases, the broker reports your cost basis as what you actually paid for the shares (the discounted purchase price), not the fair market value at purchase. The discount portion, however, has already been included in your W-2 as ordinary income.

If you carry the broker's reported basis straight onto Form 8949 without adjustment, you pay capital gains tax a second time on income that has already been taxed once as ordinary income. The adjustment is small in administrative terms (a code B on Form 8949 with a positive basis adjustment) but the dollars at stake are not small. On a \$40,000 sale where the discount-related ordinary income was \$8,000, failing to adjust the basis means paying capital gains tax on an extra \$8,000 of phantom gain. At a 20 percent rate that is \$1,600, repeated every year you sell ESPP shares without catching the error.

This is the single most common ESPP tax error and it shows up on returns prepared by people who otherwise file accurately. The information needed to fix it is on Form 3922, which your employer issues for each year of ESPP purchases.

SECTION 2

Restricted Stock Units (RSUs)

3. How much was withheld at my last vest, and was it actually enough?

When Restricted Stock Units (RSUs) vest, the fair market value of the shares is taxed as ordinary income immediately. The default federal supplemental withholding rate on this income is 22 percent. If your total income puts you in the 32, 35, or 37 percent federal bracket, every vest is systematically under-withheld at the federal level, and the gap compounds quietly across the year.

The number to watch is not the percentage withheld but the cumulative shortfall. A high earner with \$200,000 of vesting income at a 37 percent marginal rate is short roughly \$30,000 of federal tax by April. The fix is either an estimated quarterly payment to the IRS, an adjustment to W-4 withholding earlier in the year, or a request to your employer's equity portal to withhold at a higher rate (some plans allow this on a sliding scale up to 37 percent).

4. Am I holding shares past vest intentionally, or by default?

Holding RSU shares after they vest is mathematically the same as taking the after-tax cash and using it to buy your employer's stock on the open market. The ordinary income tax is already settled at vest. Any future gain or loss is purely a function of whether you would, today, choose to invest new money in this specific stock.

For someone whose salary, bonus, and other equity are all tied to the same company, the answer to that question is often less obvious than it first appears. The post-vest hold decision is the place where tax concerns and concentration risk meet most directly, and where the risk of staying the same can quietly compound past the point of comfort.

Callout: The \$1 Million Trigger

Once your cumulative supplemental wages (RSU vests, bonuses, and similar) cross \$1 million in a calendar year, federal withholding on the excess jumps from 22 percent to 37 percent automatically. This is common at executive levels, in IPO years, and after refresh grants land on top of an already large grant schedule. Knowing where you sit relative to that threshold mid-year matters for cash flow planning, especially if a large vest is scheduled in Q4.

SECTION 3

Stock Options (ISOs and NSOs)

5. Are my options Incentive Stock Options (ISOs), Non-Qualified Stock Options (NSOs), or a mix?

The two are taxed under completely different rules and the planning around them is not interchangeable. Incentive Stock Options (ISOs) get preferential treatment if the shares are held long enough after exercise, but exercising them can trigger the Alternative Minimum Tax (AMT). Non-Qualified Stock Options (NSOs) are taxed as ordinary wage income at exercise, on the full spread between the strike price and the fair market value, with payroll taxes withheld at exercise.

Many grant packages include both. Your option grant agreement or your equity portal will specify which type each tranche is.

6. If I have ISOs, am I exercising and holding past year-end?

This is the AMT trap. Exercising ISOs and holding the shares past December 31 means the bargain element (the spread between the strike price and the fair market value at exercise, times the number of shares) becomes a preference item in the Alternative Minimum Tax calculation for that tax year. You can owe a meaningful AMT bill on paper gains, with no cash from a sale to pay it.

The trap gets worse if the stock falls after exercise. The AMT calculation is locked at the exercise-date price. A stock that drops 60 percent between exercise and year-end still produces an AMT bill based on the original spread. There is no automatic relief mechanism. The AMT credit that arises in later years can take a long time to recover and may never be fully used.

7. If I have NSOs, have I modeled the cash needed to exercise plus the tax owed at exercise?

Exercising NSOs requires paying the strike price for the shares, and at the same moment generates ordinary income equal to the spread between the strike and the fair market value. That income is subject to federal tax, state tax, Social Security tax up to the wage base, and Medicare tax. The supplemental withholding rate often falls short of the true marginal rate, the same shortfall problem as RSUs.

A grant of 10,000 NSOs with a \$5 strike at a \$50 fair market value requires \$50,000 in cash to exercise, generates \$450,000 of W-2 income, and produces a substantial federal, state, and payroll tax bill against that income. A cashless exercise (where the broker sells enough shares to cover strike plus tax) solves the cash flow problem but eliminates any future upside on the shares that get sold. The choice between holding back cash or selling shares to cover involves the same concentration question as RSUs.

REFERENCE

Where to find this information

The information needed to answer the questions in this checklist is on specific forms, in specific places:

- ESPP purchases are reported on Form 3922, issued by your employer for each year of purchases.
- ISO exercises are reported on Form 3921, issued by your employer for each year of exercise.
- RSU vest income is included in W-2 box 1, with some employers providing a supplemental detail statement.
- All stock sales are reported on Form 1099-B from the broker holding the shares (this is where the basis trap shows up).
- The AMT calculation lives on Form 6251.
- Your equity portal, whether Fidelity Stock Plan Services, Schwab Equity Awards, E*TRADE, Morgan Stanley at Work, Carta, or another provider, usually has a tax documents section where these forms and supporting detail can be downloaded.

If you cannot find an answer in those forms, your equity team at the employer or the recordkeeper running the plan can usually help.

Want to talk through your specific situation?

If you would like to talk through anything in this checklist as it applies to your specific equity comp picture, you can reach me directly. The first conversation is 30 minutes, free, and not a sales pitch. If we are not the right fit, you will know in the first ten minutes.

Email: zac@waterfallplanning.com

Schedule a call: waterfallplanning.com/talk-to-an-advisor

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ABOUT THE AUTHOR



Zac Murphy, CFA, CFP®

Zac Murphy is the founder of Waterfall Planning. He holds the Chartered Financial Analyst designation and is a CERTIFIED FINANCIAL PLANNER™ professional, a combination held by a small subset of financial advisors in the United States.

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