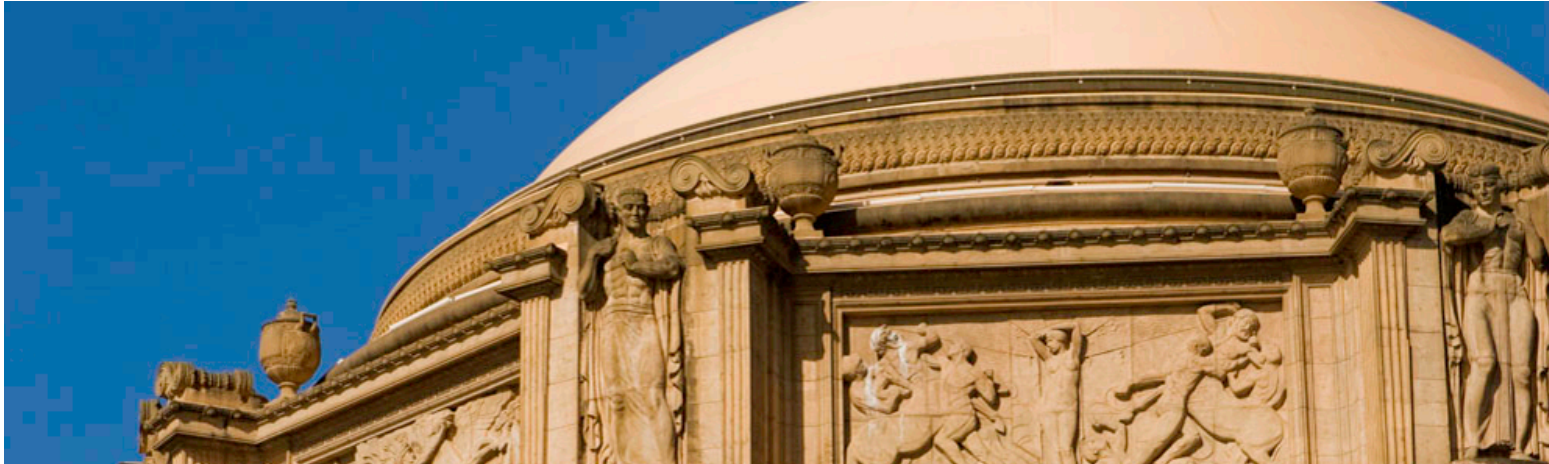


# Stock Option Counsel



- ESPP How-To #1: Timeline the ESPP
- ESPP How-To #2: Learn the Discount
- ESPP How-To #3: Calendar Your Bets
  - ESPP How-To #4: Tax Basics

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# General Info Only

- This is for general information only. It addresses only U.S. federal income tax consequences of the enrollment and sale in a hypothetical ESPP. It is not tax advice or legal advice for your personal situation. If you want to engage us as Stock Option Counsel, please contact us at [www.maryrusselllaw.com](http://www.maryrusselllaw.com).
- The analysis is based on a tax-qualified ESPP with a two-year Offering Period with four purchase periods, a two-year Look Back and a 15% discount.
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# ESPP How-To #4: Tax Basics

- The first two slides cover the tax basics for enrollment in the ESPP, the purchase date of ESPP stock, and the sale of ESPP stock.
- The remainder of the presentation is more in-depth information on tax consequences of the sale of ESPP stock.

# ESPP Tax: Enrollment and Purchase

- Enrollment: The payroll deduction percentage you choose during Open Enrollment is calculated on pre-tax income but taken after taxes. Therefore:
  - If your salary and bonuses equal \$100,000, a 10% contribution percentage will result in a \$10,000 investment in the ESPP.
  - You will pay income and payroll taxes on the \$10,000 investment, so your take-home pay will be reduced by the \$10,000 as well as the tax on the \$10,000
- Purchase Date: The Purchase Date is not a taxable event, so you do not pay taxes at purchase. However, discount on the Purchase Price is a benefit to you from the company, so you will pay taxes on that discount as if it were compensation when you sell or transfer the ESPP stock.

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# ESPP Tax: Sale of Your ESPP Stock

- If you sell your ESPP stock before the expiration of a 1-2 year Holding Period following the Purchase Date (this early sale is called a Disqualifying Disposition), you are likely to pay more in taxes than if you sell after the Holding Period. Why?
  - Taxable Income: Your taxable income on a Disqualifying Disposition may be greater than your Gain on Sale.
  - Tax Rates: Your tax rates on your taxable income may be higher because a greater portion of your taxable income is likely to be taxed as Ordinary Income rather than Capital Gains.

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# End of Basics

- You can stop reading now. That's all you need to know about tax to enroll in your ESPP.
- If you want to know the details of how the sale or transfer of ESPP stock will be taxed, read on.

# ESPP Tax: Holding Period Calculation

- Disqualifying Disposition = Transfer of ESPP stock before the end of the Holding Period.
- The Holding Period ends on the LATER of:
  - One Year and one day after Purchase Date or
  - Two Years and one day after Offering Date

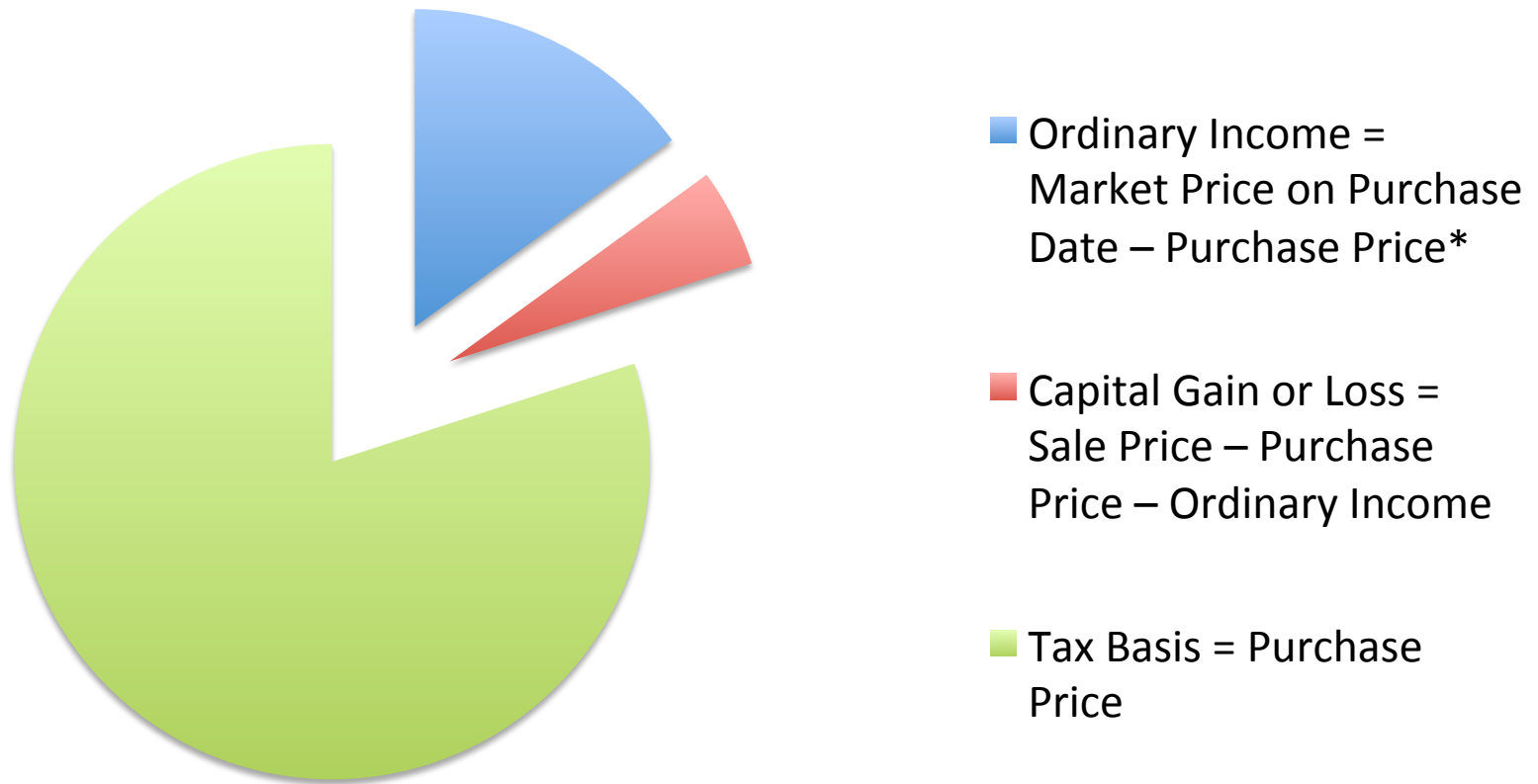
## Holding Period Calculation Example

### Two-Year Offering Period Starting January 1, 2013 With Four Purchase Periods

	Purchase Date	Disqualifying Disposition Holding Period Ends
Purchase Period #1	June 28, 2013	January 2, 2015
Purchase Period #2	December 31, 2013	January 2, 2015
Purchase Period #3	June 30, 2014	July 1, 2015
Purchase Period #4	December 31, 2014	January 1, 2016

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# Tax on Sales Price at Disqualifying Disposition

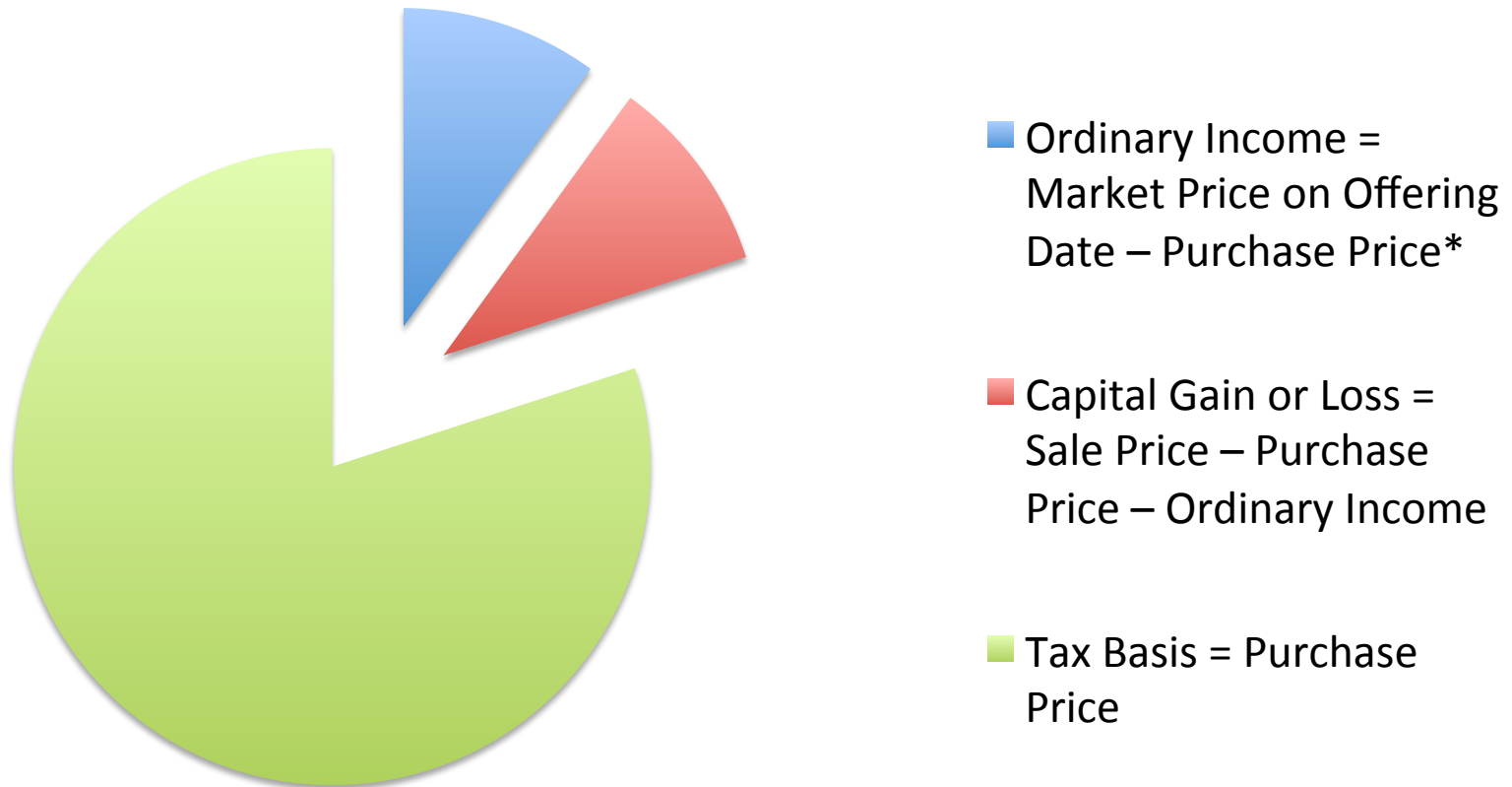


\* In a Disqualifying Disposition, Taxable Income is NOT Limited to Gain on Sale. Therefore, Ordinary Income on Disqualifying Disposition May Be > Gain on Sale.

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# Tax on Sales Price at Qualifying Disposition



\* In a Qualifying Disposition, Taxable Income is Limited to Gain on Sale. Therefore, Ordinary Income = ZERO in a Qualifying Disposition if Sale Price  $\leq$  Purchase Price.

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# ESPP Tax: Taxable Income

- Disqualifying Disposition: Ordinary Income = Market Price on Purchase Date – Purchase Price. This is not limited to Gain on Sale (Sale Price – Purchase Price).
- Recognize Gain on Sale for Loss: If you sell at a loss (Sale Price < Purchase Price), you may owe taxes when you have no profit.
  - i.e. \$12 Market Price on Purchase Date. Purchase Price of \$8.50 (based on Look Back to Offering Date Market Price of \$10). Sale for \$6. In a Disqualifying Disposition, you would have Ordinary Income of \$3.50 per share, even though you have sold for a loss.
- Taxable Income May Be > Gain on Sale: If the market price decreases between the Purchase Date and the date on which you sell your stock, you may report Ordinary Income greater than your Gain on Sale.
  - i.e. \$12 Market Price on Purchase Date. Purchase Price of \$8.50 (based on Look Back to Offering Date Market Price of \$10). Sale for \$10. In a Disqualifying Disposition, you would have Ordinary Income of \$3.50, even though your gain is only \$1.50.

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# ESPP Tax: Tax Rates

- Taxable income on sale of ESPP stock is divided between Ordinary Income and Capital Gains. Most taxpayers would prefer that their income be taxed as Capital Gains rather than as Ordinary Income because Long Term Capital Gains tax rates are significantly lower than Ordinary Income tax rates.
- A Disqualifying Disposition is likely to result in more Ordinary Income than a Qualifying Disposition.
- Qualifying Disposition: Ordinary Income = Market Price on Offering Date – Purchase Price (but only up to the amount of Gain on Sale)
  - Example: Market Price on the Offering Date = \$10. Market Price on Purchase Date = \$12. Purchase Price = \$8.50. Sale Price = \$14.
  - Qualifying Disposition: Ordinary Income = \$1.50. Capital Gains = \$3.50.
  - Disqualifying Disposition: Ordinary Income = \$3.50. Capital Gains = \$1.50

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# Disqualifying Disposition Advantage?

- Note that Ordinary Income on a Qualifying Disposition is based on the Market Price on the *Offering Date*, and Ordinary Income on a Disqualifying Disposition is based on the Market Price on the *Purchase Date*.
- Therefore, if the Market Price drops during the Offering Period with a Look Back, a Qualifying Disposition may lead to greater Ordinary Income than a Disqualifying Disposition.
  - Market Price on Offering Date of \$12. Market Price on Purchase Date of \$10. Purchase Price of \$8.50. Sale Price of \$15.
  - Qualifying Disposition: Ordinary Income = \$3.50. Capital Gains = \$3.
  - Disqualifying Disposition: Ordinary Income = \$1.50. Capital Gains = \$5.
  - You can avoid this by selling before the Holding Period ends.
- Long Term v. Short Term Capital Gains: Disqualifying Disposition is unlikely to lead to a lower tax rate in this situation, as the rates for Short Term Capital Gains = Ordinary Income rates. Only a Disqualifying Disposition that also meets the requirements for Long Term Capital Gains rates (a one-year holding period) would be more advantageous than a Qualifying Disposition in this situation.

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# ESPP Tax: Conclusions

1. Disqualifying Disposition = Transfer of Stock before the later of:
  - Two years and One Day from Offering Date
  - One Year and One Day from Purchase Date
2. Disqualifying Disposition may lead to more taxable income on the sale of ESPP stock when:
  - Sale Price < Purchase Price
  - Market Price at Purchase Date – Purchase Price > Gain on Sale
3. Disqualifying Disposition may lead to higher tax rates, so long as the Market Price on the Offering Date is  $\geq$  Market Price on Purchase Date

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Maximize your employment compensation with attorney evaluation of your stock options or other employee stock. We bring Silicon Valley legal expertise to your evaluation of your: Stock Options, Restricted Stock, Restricted Stock Units, Employee Stock Purchase Programs, Stock Grants, Phantom Stock, Deferred Compensation, Offer Letters, Employment Agreements, and Independent Contractor Agreements.

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