# Understanding the Tax Treatment of Your ESPP

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An employee stock purchase plan (ESPP) provides you with a convenient way to purchase company stock, often via payroll deduction. Like the way you contribute to a 401(k), you can easily allocate money to the ESPP via your paycheck.

In addition, your ESPP may offer a purchase discount of up to 15%, allowing you to buy company stock at a cheaper price than what you could have in a typical investment account.

Because your stock shares accumulate in a non-IRA/brokerage investment account, income tax is an important consideration when you have an ESPP. More than one type of income tax can apply depending on several factors: how long you hold the shares, purchase price, discount applied, and amount of gain or loss.

Here's how to sift through the details to better understand your potential tax obligations.

## ESPP TAX AT PURCHASE

When you buy shares via an ESPP, no tax is due, and no tax is reported. It's as if you purchased shares on the open market. Even if the shares are purchased at a discount from the current market price, no tax is due. However, that doesn't mean that the information pertaining to the purchase price and the discount applied is irrelevant. In fact, both the purchase price and the discount are important when calculating potential taxes you will owe.

When you sell shares acquired via your ESPP, special tax rules dictate what and how much will be reported as "earned income," "capital gain," and "capital loss" (subject to short-term and long-term holding periods).

## QUALIFYING VS. DISQUALIFYING DISPOSITION OF ESPP SHARES

An ESPP comes with special holding periods that dictate if gains on the sale are treated as earned income or long-term capital gains. These holding periods result in either a qualifying disposition or a disqualifying disposition.

A qualifying disposition of ESPP shares is anything that meets the following criteria:

- The stock is sold at least one year past the original purchase date **and**
- The stock is sold at least two years after the original offering (grant date)

Anything that does not meet these standards is a disqualifying disposition of ESPP shares.

From a tax perspective, you generally have two brackets to consider when determining what tax may be owed:

- A portion of the proceeds that will be taxed as earned income
- A portion of the proceeds that will be taxed as a capital asset (short-term or long-term capital gains)

## SCENARIO 1:
## TAX FOR A QUALIFYING DISPOSITION OF ESPP SHARE

If you meet the criteria for a qualifying disposition, you will likely report both earned income and long-term capital gain income.

Let's assume that you purchase shares of stock through an ESPP with a 15% discount. You buy shares at $17 per share (a 15% discount from the $20-per-share price).

Let's also say you later sell the shares at $30 per share. The total gain on this transaction will be $13 per share, or $30 less the $17 you paid for the share.

The value of the discount received will be treated as earned income. In this example, $3 is subject to ordinary income rates. The remainder, $10, is treated as a long-term capital gain subject to preferential capital gains tax treatment.

If we calculate the after-tax impact using simple tax assumptions (33% for earned income and 15% for long-term capital gains), we can illustrate the benefit of a qualifying disposition vs. disqualifying disposition (all else being equal):

### QUALIFYING DISPOSITION

- $30 sales price
- $13-per-share gain
- 33% tax on $3 = $0.99
- 15% tax on $10 = $1.50

**After-tax profit** = $10.5

### DISQUALIFYING DISPOSITION

- $30 sales price
- $13-per-share gain
- 33% tax on $13 gain = $4.29

**After-tax profit** = $8.71

The qualifying disposition results in over 20% greater after-tax wealth.

## SCENARIO 2:
## DISQUALIFYING DISPOSITION RESULTING IN SHORT-TERM CAPITAL GAIN

Let's assume you purchase shares of stock through an ESPP with a 15% discount. The price at the beginning of the offering period was $20 per share, and at the end of the offering period, it's $25 per share. That means you can buy shares of the company at $17 per share, a 15% discount from $20 per share (the lower of the two).

Now, let's say you eventually sell your shares (assuming a disqualifying disposition) at $30 per share. The total gain on this transaction will be $13 per share, or $30 (the final sale price) less $17 (the original price paid).

Because this is a disqualifying disposition, you pay ordinary income tax on the discounted purchase price ($17) to the price of the stock at the end of the offering period ($25), or $8 per share. This then increases the cost basis of the stock to $25.

The final sales price ($30 per share) less the cost basis ($25) equals the amount treated as a capital gain ($5). Assuming less than a 1-year holding period, a short-term capital gain is taxed as ordinary income.

## SCENARIO 3:
## WHAT HAPPENS IF YOUR SHARE PRICE FALLS

What happens if the share price goes down after the purchase of the shares? In this scenario, it's possible that you could report both earned income and a capital loss.

Continuing the Scenario 1 example from above, let's assume that the final sale price of the stock is $15 per share (as compared with $30 per share). You need to report earned income equal on the spread between the discounted purchase price ($17) and the price at the end of the offering period ($25), or $8 per share.

When you report and pay tax on the earned income above, your cost basis increases to $25 per share (as compared with the $17 originally paid). This adjusted cost basis, less the final sale price, will be treated as a capital loss. In our scenario, $25 – $15 = $10 per share.

## BALANCING TAX PLANNING WITH INVESTMENT RISK TOLERANCE

An ESPP can be a great way to participate in a growing company through the purchase of company stock. In many cases, participating in a good ESPP plan is a no-brainer when it comes to generating additional wealth.

But that does not mean that holding the shares for the long term is best.

If you use an ESPP, you may find yourself accruing shares. As these shares accumulate and become an increasing percentage of your net worth, it's important to consider not only how that kind of asset fits into your financial plan, but also what the tax consequences of a massive sale of those assets could be.

It's easy to think a qualifying disposition of ESPP shares is the way to go as it minimizes your tax bill. All else being equal, this is arguably true; paying less tax would be a good thing.

Unfortunately, the desire to pay less tax requires you hold your shares long enough to meet the standard of a qualifying disposition. Holding company shares may lead to an increase in concentration risk and volatility risk.

While this may work in your favor if the stock price goes up, it also has the capability to reduce your wealth if the stock price goes down.

Therefore, it's important to balance your tax planning objectives with your **investment risk tolerance**. Combining this information with a detailed tax analysis can help you understand what your tax may look like.

### Schedule a **complimentary meeting** with a wealth advisor to discuss your personal situation.

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None of the information in this document should be considered as tax advice. You should consult your tax advisor for information concerning your individual situation.