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Equity Compensation: **A Simple Guide to ISOs,** **NSOs, and RSUs**



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Common types of equity compensation include Incentive Stock Options (ISOs), Non-Qualified Stock Options (NSOs), and Restricted Stock Units (RSUs). Each works differently and has its own tax rules, but they all give you an opportunity to build wealth if the company performs well. This guide explains these options in simple terms to help you understand what they mean for you and your family.

What Is Equity Compensation?

Equity compensation means receiving an ownership interest in a company as part of your compensation package. Instead of receiving only a salary, you might receive the right to purchase company stock at a set price through stock options or receive company shares over time through RSUs. Both publicly traded and privately held companies can offer equity compensation, and each presents unique considerations.

Common Incentive Types:

- **Incentive Stock Options (ISOs):** These allow employees to purchase company stock at a fixed price, often below its market value, with potential tax benefits if certain requirements are met.
- **Non-Qualified Stock Options (NSOs):** These also allow you purchase stock at a set price, but they are more flexible and can be granted to employees, contractors, or others. They are generally subject to different tax treatments than ISOs.
- **Restricted Stock Units (RSUs):** These are promises to deliver company shares after certain conditions are met, such as remaining with the company for a specified period. There is no upfront purchase cost, but the shares are generally taxable when they vest.
- **Exercise Price/Strike Price:** The fixed price at which an employee can purchase stock under a stock option agreement.
- **Fair Market Value (FMV):** The current value of a company's stock used to determine the value of equity awards and, in some cases, their tax implications.
- **Cliff:** A period, often one year, during which no equity vests, after which a portion or all of the equity vests.
- **409A Valuation:** An independent appraisal of a private company's stock value used to establish option exercise prices in accordance with IRS rules.

Understanding ISOs, NSOs, and RSUs

Let's break down how each type works with a simple example. Imagine you work for a company where the stock is worth \$20 per share today.

Incentive Stock Options (ISOs)

ISOs allow you to purchase stock at a set price, known as the strike price, in the future. Say you receive 1,000 ISOs with a \$20 strike price. If the stock rises to \$50 in three years, you can purchase 1,000 shares for \$20,000, and then sell them for \$50,000, resulting in a \$30,000 gain before taxes.

ISOs may offer tax advantages. Generally, you do not recognize regular income when you exercise the options, but the difference between the exercise price and the fair market value may be subject to Alternative Minimum Tax (AMT). To qualify for favorable long-term capital gains treatment, you generally must hold the shares for at least one year after exercising and two years after the grant date. Only employees can receive ISOs, and there is a \$100,000 annual limit based on fair market value of shares that first become exercisable.

Non-Qualified Stock Options (NSOs)

NSOs are similar but more flexible. You might receive 1,000 NSOs with a \$20 strike price. If the stock reaches \$50, you can purchase the shares for \$20,000 and sell for \$50,000, resulting in a \$30,000 gain.

When you exercise NSOs, the difference between the fair market value and the exercise price, known as the spread, is generally treated as ordinary income. For employees, this amount is typically reported on your W-2. If you later sell the shares, any additional gain or loss is generally based on the difference between the sale price and the value used when you exercised. If you hold the shares for more than a year, that additional gain may qualify for long-term capital gains treatment.

NSOs can be granted to employees, contractors, advisors, and others, making them common in startups and private companies.

Restricted Stock Units (RSUs)

RSUs are a promise to deliver company shares after you meet certain conditions, usually remaining with the company for a specified period. If you receive 1,000 RSUs and the stock is worth \$50 when they vest, you receive \$50,000 worth of shares. That \$50,000 is generally treated as ordinary income when the RSUs vest and is typically reported on your W-2 for employees. Your company may withhold or sell some shares to cover taxes. If you hold the remaining shares and later sell them for \$60, the additional gain is generally treated as a capital gain. If you hold the shares for more than one year, the gain may qualify for long-term capital gains treatment.

RSUs are generally simpler than stock options because there is no purchase price, but you have less control over when the income is recognized because taxation generally occurs when the RSUs vest.

Things to Think About Before Acting

Taxes Can Be Tricky

ISOs may trigger Alternative Minimum Tax (AMT) when you exercise, particularly when the difference between the exercise price and fair market value is significant. NSOs and RSUs generally create taxable income when you exercise or when the RSUs vest, respectively, so it is important to plan for the resulting tax liability. For example, if 500 RSUs vest at \$100 per share, you will have \$50,000 of taxable income. The amount of tax you owe will depend on your circumstances and applicable tax rates, which could be as much as 37%. A tax advisor or one of our financial planners can help you prepare.

Timing Matters

With ISOs and NSOs, you have flexibility over when to exercise, which can help manage the tax impact. For instance, exercising NSOs in a year when your income is lower might reduce the applicable tax rate. RSUs are taxed when they vest, so you have less control over the timing of the taxable event. Consider your income, tax situation, and the company's stock price before making moves.

Consider the Risk of Value Changes

Equity compensation depends on the company's stock price, which can rise or fall. Determining fair market value can be particularly challenging for privately held companies. If the stock falls below your strike price, an option may no longer be worth exercising. RSUs retain value as long as the stock price remains above \$0, but their value can decline if the stock price falls. Consider how much exposure to your employer's stock is appropriate for your overall financial situation.

Vesting and Job Changes

If you leave the company before your equity vests, you may lose unvested ISOs, NSOs, or RSUs. For ISOs, you usually have 90 days after leaving to exercise vested options, although the specific terms of your plan may vary. In some circumstances, options may lose their ISO tax treatment and be treated as NSOs. Review your plan documents so you understand what happens to your equity if you change jobs.

Consider Your Long-Term Goals

Equity can help support goals like retirement or buying a home, but it works best if you can wait for anticipated growth of the stock. If you need cash in the near term, selling RSUs right after vesting might help, but holding longer could mean lower taxes. Think about what you want for your future and your tax sensitivity. Planning plays an important role in determining the best solution and coordinating with a tax attorney.

How to Handle Taxes

You can use cash from your savings to pay taxes associated with NSOs or RSUs, allowing you to retain your shares. Alternatively, you can sell shares to cover taxes. While selling shares may limit your potential for future gains, it can preserve cash reserves for other needs and reduce your exposure to a single company's stock. For ISOs, plan for possible AMT costs when exercising. The potential AMT liability can be significant depending on your income and the difference between the exercise price and fair market value.

For tax year 2026, the exemption amount for unmarried individuals is \$90,100 and begins to phase out at \$500,000. For married couples filing jointly, the exemption amount is \$140,200 and begins to phase out at \$1,000,000.¹

Some employers may require shares to be sold or withheld to cover taxes, leaving you with limited flexibility. A tax advisor or financial planner can help you evaluate the available options.

You Don't Have to Decide All at Once

You can exercise options or sell shares over time to spread out the tax impact and manage risk. For example, you might exercise 25% of your ISOs each year over four years to keep your income steady. RSUs vest according to a predetermined schedule, so you can decide whether to sell or hold each group of shares as it vests.

Think About Your Dreams

Equity compensation is most rewarding when it fits your life goals. If you want to grow your savings, holding RSUs or ISO shares for long-term gains might be great. If you need cash now, selling NSOs or RSUs after vesting could help. Talk through your plans with an advisor to make sure your equity supports you and your family and risk tolerance.



How Parallel Advisors Can Help

Equity compensation can be complex and confusing. Our planning team will work with you to develop an exercise strategy, evaluate tax considerations, and incorporate your equity compensation into a comprehensive financial plan.

Final Thought

Equity compensation can provide an opportunity to build wealth as your company grows. ISOs, NSOs, and RSUs each have their own rules and tax considerations, but they can all give you an opportunity to participate in the company's future. With thoughtful planning, you can make informed decisions about your equity while managing taxes, risk, and your broader financial goals. We are here to help you understand your options and develop a strategy that fits your financial plan.

¹ <https://www.irs.gov/newsroom/irs-releases-tax-inflation-adjustments-for-tax-year-2026-including-amendments-from-the-one-big-beautiful-bill>

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