Farther

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Framework for Managing Stock Options

Many companies — especially large tech companies — use equity as a significant component of their employee compensation packages. While equity compensation is often lucrative for employees, it also comes with risks: including an overly concentrated portfolio and additional tax complexities.

For example, if the value of your own company's stock holdings and grants account for more than 5% of your total investment portfolio, then you are most likely not sufficiently diversified. While you may be confident in your company's future, your portfolio likely has more risk than prudent (when considering the potential returns). However, selling too much stock too quickly — without paying attention to tax implications — could leave you with a big surprise from the IRS at the end of the year.

The Think! Don't Concentrate Framework provides a methodology to determine what percentage of your company stock to hold — in order to maximize your returns, while minimizing risk and avoiding unnecessary taxes.

First, an Overview of Equity Compensation Types

Before diving in, here is a brief overview of common equity compensation plans and their tax implications:

TYPE	NAME	OVERVIEW	TAXATION
RSUs	Restricted Stock Units	A grant in full stock shares (not options) redeemable, per a pre-defined vesting schedule	Shares are taxed as ordinary income, based on the fair market value at the time of redemption
ESPPs	Employee Stock Purchase Plans	An employer sponsored plan that allows you to buy shares at a discount (usually 15%)	The difference between the purchase price and fair market value is taxed as ordinary income at sale
NSOs	Non-Qualified Stock Options	An option to buy shares without potential tax benefits on the profits at the time of redemption	The gain (difference between the strike price and fair market value) is taxed as ordinary income at time of exercise
ISOs	Incentive Stock Options	An option to buy shares and sell, when vested, or to (not sell and) hold for the long-term	Multiple taxation (complex) scenarios, including Alternative Minimum Tax (AMT) liability

Source: Farther 2021

Diversification

Regardless of the type of equity compensation, it is important to remember that while concentrated holdings make you wealthy, it is diversification that keeps you wealthy. Decades of research have proven that diversification pays off; however, there are many inherent human biases that get in the way of being a rational investor. Yes, the upside of holding your company shares is that, if your company is on an upswing, you are too. But if there is an unexpected market correction, or bad news about your company is broadcasted on the morning radio, it is usually too late to prevent big losses.

Up until 2021, for example, Tesla was on fire. If you had TSLA stock options, then you were sitting pretty. But starting in early 2021, the shares flattened out. If you needed cash for a short-term goal such as a house, or for retirement, you had to swallow a -$275 (-30%) drop over the preceding 6 months. Even the highest flying stocks eventually come back to earth.

Tesla (TSLA) share price from January 2021 to June 2021

We have established the importance of diversifying your portfolio; however, you must accomplish this strategically because of the tax implications of selling equity.

For ESPPs, NSOs, and RSUs: taxation is relatively straightforward. When you exercise and sell (redeem) your shares, the value or gain you earn is treated as ordinary income. However, you don't want to unnecessarily drive yourself into a higher tax bracket by selling just a handful more shares than you really need. Therefore, it is important to carefully evaluate exactly how many shares to sell each year, in order to stay below the next highest ordinary income tax bracket.

ISOs are much more complex. If you exercise and hold ISOs: you may subject yourself to Alternative Minimum Tax (AMT) liability, without ever receiving cash. Then, if the share price drops: you could end up paying much more in taxes than you make in profits on the sale. Usually, the best strategy is to calculate your AMT crossover point, in which any additional exercise and holding of ISOs triggers an AMT liability that is greater than your ordinary income tax.

So, how do I determine how much of my company's stock I should keep?

While there have been many corrections and downturns in the past, there have also been many equity compensation success stories. Despite the risk and volatility involved, it may make sense to keep some degree of calculated concentration risk. After all, it is not easy to get into a well-managed company and then wait for shares to vest. It can take years of successful career management to get into an in-the-money stock options position. Therefore, selling off all of your own company stock position too fast, in an effort to diversify, may prematurely choke off near high-growth returns — in addition to incurring a large tax bill.

Think! Don't Concentrate — Investment Framework

Here are 5 steps to determine how much of your investment portfolio you should keep in company stock:

1. Determine the % risk of your stock in your portfolio	Assess the current impact of your company stock, based on empirical measures of risk (standard deviation %) and its correlation to the market (as measured by beta), and model your entire portfolio.
2. Get 3rd party research on your company and sector	Get independent 3rd party research on your stock. Don't let your strategy be based on the glowing optimism shared by your CEO at your last internal company get together.
3. Consider your retirement dependency	If the fate of your retirement is tied to the day-to-day share price of your company, then diversification is an immediate priority. If you are still decades away from retirement, then you can afford to be more aggressive.
4. Understand the tax consequences	Model your redemption proceeds and determine how they will impact your taxes (tax brackets). For ISO exercises, model the Alternative Minimum Tax impact (AMT) and crossover threshold.
5. Select your risk/return & target % holding strategy	Use benchmark portfolios (e.g., the S&P 500) to interactively model your risk tolerance % vs. expected return % — in order to pinpoint your company stock target % (including a multi-year strategy to reach it).

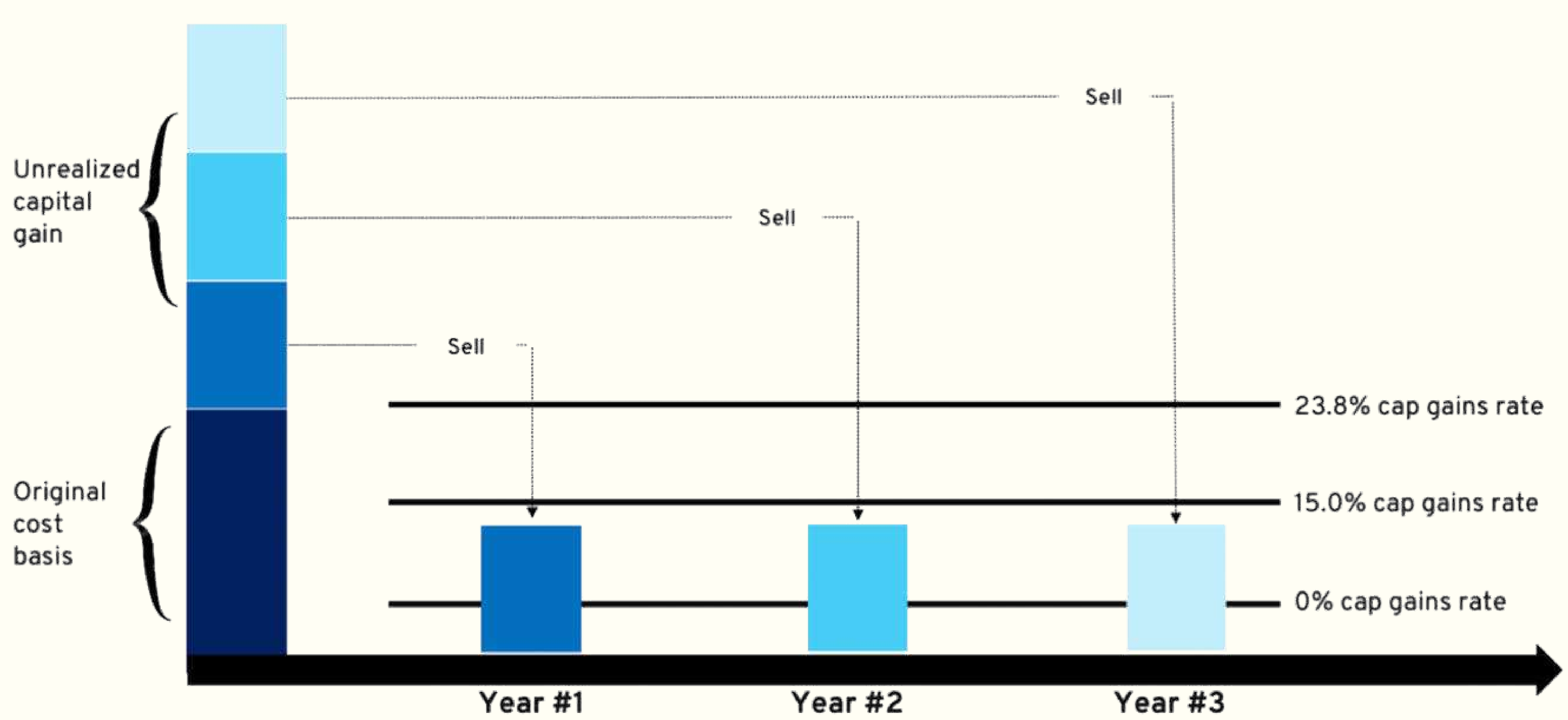
Source: Farther 2021

Downsizing Strategies

Once you have decided how much of your portfolio you want to maintain in company stock, it's time to create a plan for how to diversify the rest.

1. Selling in Stages

Sell off unrealized gains periodically, while minimizing capital gains taxes each year



Source: Farther 2021

This approach is the most widely used. To minimize taxes from selling your stock in any one calendar year: you may want to take a multi-year approach, by carefully avoiding higher capital gains tax brackets in any given year. This strategy can be accomplished while selling off only a portion of your holdings each year to eventually reach your target allocation percentage. There may even be a way to sell off some of your non-publicly traded shares in private exchanges.

2. Gift Some Stock to a Nonprofit

If you donate stock (rather than cash) to a qualified nonprofit: you can receive a tax deduction for the full market value of the stock (up to a percentage of your total income) and avoid a large capital gains tax. This strategy enables you, rather than the government, to determine the causes your money should be applied to.

3. Gift Some Stock to Your Family

The tax law allows you to gift some of your stock to your family and avoid being taxed on the gifted amount. And since some of your family members (your children, for example) are likely to be in a lower tax bracket than you, the capital gains taxes (if they sell the stock) could be lower.

4. Use of a Trust

For higher net worth individuals: it may make sense to engage in a trust. A trust can be used to minimize state income tax when selling stock options. Alternatively, your company stock could be transferred to a charitable remainder trust — and in return, you could receive an annual income stream from the trust (while avoiding a long-term capital gain).

A Comprehensive Financial Plan is the Best Approach

The Think! Don't Concentrate Framework above will provide a methodology to set your target company stock options (and holdings) weighting (by percentage) — while managing your year-to-year taxation liability, thus avoiding unnecessarily bumping yourself into a higher tax bracket and setting you up for an unexpected tax bill.

Example of incorporating equity compensation into a financial plan

Total

Total | Current plan

		Shares							Cash Flows			Taxes		
Year	Age	New Grant	Shares Vested	Shares Exercised	Vested and Exercisable Shares	Unvested Shares	Shares Sold	Shares Held	Cost of Exercise	Sale Proceed	Net Cash Flow	Ordinary Income	Short-term Gain	Long-term Gain
2022	53/47	0	3,331	0	0	7,451	5,872	0	0	316,585	316,585	179,612	0	11,079
2023	54/48	0	3,331	0	0	4,122	3,331	0	0	195,418	195,418	195,418	0	0
2024	55/49	0	2,389	0	0	1,734	2,389	0	0	152,456	152,456	152,456	0	0
2025	56/50	0	1,734	0	0	0	1,734	0	0	120,367	120,367	120,367	0	0
2026	57/51	0	0	0	0	0	0	0	0	0	0	0	0	0
2027	58/52	0	0	0	0	0	0	0	0	0	0	0	0	0
2028	59/53	0	0	0	0	0	0	0	0	0	0	0	0	0
2029	60/54	0	0	0	0	0	0	0	0	0	0	0	0	0

To ensure that you are getting the maximum value, however, it is best to look at your equity compensation as part of creating a comprehensive financial plan. This strategy will enable you to model "what if" scenarios to understand how different choices could impact your short- and long-term outcomes.

Working alongside a financial planner (and a CPA or attorney for more complex legal scenarios) is encouraged. At Farther, we help our clients design a tailored to achieve their unique goals — ensuring that you are not missing any opportunities to optimize your finances and overall estate, while minimizing your taxes.