

COMPENSATORY STOCK OPTIONS: WHEN TO HOLD AND WHEN TO FOLD

By Scott A. Leonard

The use of options for compensation has substantially increased over the past years. But the positive press generated by the "dot-com" stock craze, compounded with recent record-setting large-cap stock returns, has created a false sense of security.

It is becoming much more common today for individuals to have a percentage of their employee compensation paid in the form of stock options.

However, this form of compensation does not come without certain risks and complications. This article addresses some of the risks associated with compensation in stock options. It also provides an overview of their tax consequences and addresses some common misconceptions about the best ways to cash out of the options.

FORGOTTEN RISKS

The use of options for compensation has substantially increased over the past years. But the positive press related to the "dot-com" stock craze [Internet stocks], compounded with the recent record-setting returns of large-cap U.S. stocks, has created a false sense of security.

If you are a wage earner, one of your largest assets is your own earning potential, called *personal capital*. For a 25-year-old, right out of college, the value of this personal capital is generally the single largest asset they possess. But there are many factors that put personal capital at risk. Two of the more obvious are death or disability. Some other risks associated with personal capital are related to the profession one chooses and, more precisely, the organization one works for.

Throughout your working career, there ideally is a transfer of wealth from your personal capital to your investment capital. As a worker ages, the future amount of income they will earn slowly decreases as they approach retirement. To offset this reduction, a prudent worker will start saving part of their income from their personal capital and transfer it to their investment capital. This transfer also creates a transfer in the risks associated with the two major types of capital. Death and disability become less of an issue as far as financial risks are concerned, while the risks associated with investing increase. There are some overlapping risks, however.

Both personal capital and investment capital have company- and sector-specific risks: For personal capital, this is the company you work for and the industry in which you are employed; for investment capital, the risks are in the companies and industries in which you invest.

Since stock options are directly related to the company you are employed by, they hinder the transfer of risk from personal capital to investment capital, and thereby create a lack of diversification.

The point is, there is a very substantial risk to having your investment capital in the same company as your personal capital.

Before they are exercised, stock options have no real risk, as long as you do not "count your chickens before they are hatched." However, once stock options are exercised, it is prudent to diversify the stock as soon as possible.

Scott Leonard, CFP, is the principal of Leonard Capital Management, a Santa Monica based fee-only wealth management firm; 310/798-1503; www.LCMinvestments.com.

Mr. Leonard is a member of the National Association of Personal Financial Advisors (NAPFA), an organization dedicated to fee-only financial planning. Information on fee-only financial planners can be obtained by calling 888/333-6659, or visiting the NAPFA Web site at www.napfa.org.

The downside to this is the substantial taxation associated with an immediate exercise and sale of stock options.

THE TWO TYPES

There are two types of stock options: incentive and non-qualified. An incentive stock option (ISO) is a special type of compensatory option that satisfies qualification requirements of the Internal Revenue Code (IRC section 422(b)). An ISO gives the employee the right to purchase employer stock at a fixed price (the exercise price) for a period of time not to exceed 10 years from the date of the grant. The employee may exercise the ISO only during the time of employment with the company or a related company or within three months after termination (some special rules apply for disability).

Non-qualified stock options (NQSO) are the most common type of compensatory options. These do not meet the ISO qualification requirements and can be granted to both employees and non-employees. There are substantial differences in the taxation and rules associated with the two types of options.

Incentive stock options are extremely complicated and involve alternative minimum tax issues. In addition, incentive stock options represent only a small percentage of the stock options used by corporations. For these reasons, this article will focus on non-qualified stock options.

TAXES AND NQSOs

Non-qualified stock options are usually granted pursuant to a stock option plan. When granted, options have an *exercise price* (or *strike price*), which is the price you have to pay to purchase the stock when you decide to exercise the option. Many plans have vesting schedules, which dictate when the option can be exercised. You cannot exercise

non-qualified stock options until they are “vested.” However, the granting and subsequent vesting of stock options is not a taxable event.

A taxable event does occur, however, when the options are exercised. At that time, there are two valuations for tax purposes: the *exercise price* and the *fair market value* of the stock. The exercise price, of course, is determined when the option is granted. The fair market value is the average price of the stock for the day (not the last trade of the day).

Since there is no incentive to exercise an option when the fair market value of the stock is lower than the exercise price, that scenario is not addressed here. Instead, an individual will exercise the option when the fair market value on the day of exercise is above the exercise price. The difference between the exercise price and the fair market value the day you exercise is called *free money*. And, as with any type of financial windfall, the IRS wants its share, so the free money is taxed as regular income. Thus, the *cost basis*, used to determine tax liability when the stock is sold, for the stock is the fair market value. In addition, withholding of the tax is required. So, even if you plan to hold on to the stock once the option is exercised, you will be required to pay the exercise price *plus* the taxes due on the exercise date.

Example: Griffin has an option to buy 1,000 shares of LCM at \$10 a share. The current market price is \$15. To exercise the options, Griffin must pay \$10,000 ($1,000 \times \10) and *compensated* income taxes on \$5,000 (fair market value \$15 less the exercise price \$10 is \$5; $\$5 \times 1,000$ shares equals \$5,000). His cost basis in the stock is \$15 a share or \$15,000. Assuming a 31% federal tax bracket, his out-of-pocket cost is \$11,550 plus any state taxes (income tax of 31% on \$5,000 equals \$1,550 plus \$10,000 for a \$11,550 total). Assume three years later he sells the stock at \$23 a share; he will receive

\$23,000, of which \$8,000 will be taxed as long-term capital gains at a 20% rate (\$23,000 less his cost basis of \$15,000 equals \$8,000; 20% of \$8,000 equals \$1,600 of tax due). His net aftertax value is \$21,400.

When exercising stock options, the major complaint—and surprise—is the taxation of the difference between the exercise price and fair market value as compensated income. Additionally, this tax must be paid when the stock is exercised, even if the stock is not sold. However, once the options are exercised, if the stock is held for at least 12 months, all subsequent increases in the value of the stock will be taxed at the more favorable capital gains tax rate.

Keep in mind, too, that this discussion takes into consideration federal taxes only. There are also individual state tax issues associated with non-qualified stock options, but those are beyond the scope of this article.

EXERCISING NQSOs

The tax consequences of the timing and capital requirements for the exercising of stock options are two very important considerations. These have to be measured with respect to the diversification of capital issues addressed earlier. For the purposes of this section, let's assume that if the options are exercised, the stock is sold the same day. This is called a *cashless* transaction, and it eliminates the need to pay for the value of the exercise price and the income tax generated with capital from other resources. Instead, with a cashless transaction, these costs are taken from the gross value of the sale of the stock.

As a general rule, you do not want to exercise stock options and then hold on to the stock. The reason is simple: Once the options have been exercised, you are holding stock in the company you

work for with no additional “free money” (the difference between the exercise price and the fair market value the day you exercise the options). Since the free money element is gone, there is no added compensation for the risk of owning stock in the company for which you work.

Assuming the value of the company increases over time, the free money element will also increase until you exercise the options. However, the free money element will always be taxed as compensated income. Since this compensated income has the potential to be very large, it can “bump” you up into a higher marginal tax bracket. This bump has the effect of lowering the net value of the free money, however, it is still free money. By timing the exercise of stock options, it is possible to attempt to prevent this by not exercising enough options to bump you into the next tax bracket. Also, if you have the ability to time other income, it may be possible to stagger the years you exercise stock options with other earned income.

It is important to remember that, as long as a non-qualified stock option is not exercised, there is no money at risk. However, if the price of the stock drops at any time after you are vested, there is an unrealized loss, or paper loss, of what you could have earned had you exercised the options when the fair market value of the stock was at the higher price. Once you exercise the option, you have locked in your free money. As with any investment, timing is critical, but it is also one of the most difficult decisions to make.

One common recommendation I hear is that an employee should exercise the stock options right away, generally when the exercise price and fair market value are near each other, and hold onto the stock. Assuming the stock is held for at least 12 months, all future growth is taxed as long-term capital gains. The reasoning is that by exercising when

the exercise price and fair market value are close, you pay less in compensated income tax, which is higher than long-term capital gains taxes.

However, this scenario makes two very bad assumptions: First, it assumes you have enough cash resources to exercise the options and pay the taxes; and second, it assumes that the stock will continue to grow in value.

This scenario also makes some huge mistakes in not evaluating the larger picture—i.e., the opportunity cost of the money used to exercise the options. If the options are not exercised, the monies that would be used to exercise the options can be invested elsewhere. Conversely, once the options are exercised, there is the relative, risk-adjusted performance of the stock compared to all other investment options. Many times, employees are so caught up with their own company that they do not objectively evaluate the performance of their company's stock.

Example: Let's return to our previous example, where Griffin exercised the options when they had a fair market value of \$15,000 and sold them three years later for \$23,000. The gross before-tax rate of return on the stock during this time was an annual average return of 15.31%. When he sells the stock for \$23 a share, he has to pay long-term capital gains taxes at 20% on the growth above his cost basis of \$15. His net aftertax value is \$21,400 (sale value of \$23,000 less cost basis of \$15,000 has a taxable gain of \$8,000 for a tax of \$1,600 and a net value of \$21,400).

Option A: Instead of exercising the options, another employee, Delanie, in the exact same situation, decides to keep the cost of exercising the options in a tax-free money market account earning 2.48%. At the end of three years, her \$11,550 has grown to \$12,440. Now she does a cashless exercise of the options when they are at a fair market value of

\$23 a share, for a gross value of \$23,000. However, she has to pay \$10,000 to buy the stock, and she has to pay income taxes at 31% on the free money. The free money is the exercise price less the fair market value, or \$13 a share in this example (\$23 fair market less \$10 exercise price.); the tax on the \$13,000 is \$4,030. Her net amount is the gross amount, \$23,000, less the exercise cost of \$10,000, less her taxes due of \$4,030, for a total of \$8,970. Add that to the value of her money market at \$12,440 and her net total is \$21,410—just about the same as Griffin. However, she has taken less risk since she did not own the stock for the three-year period. Thus, if the stock lost value, the options may be worthless, but she would still have the \$12,440. In this scenario, if the stock had grown at a rate higher than 15.31%, Griffin would have been better off, and if the return had been under 15.31%, then Delanie would have been better off. However, in this example Delanie did not invest the money that could have been used to exercise the options at the earlier time, but instead simply put it in a tax-free money market account.

Option B: In this option, Delanie again decides to wait to exercise the options, but invests the money it would cost to exercise the option in the company stock. So she takes her \$11,550 and is able to buy 770 shares of LCM, based on its \$15 a share fair market value. In three years, she sells the 770 shares for \$23 a share, for a gross of \$17,710. She must pay long-term capital gains tax on the growth, which is 20% of the gain, for a tax of \$1,232 or a net amount of \$16,478. Add that to the amount she receives from exercising the options at \$23 (Option A), a net of \$8,970, and she now has a grand total of \$25,448. That equates to \$4,048 of additional money, without taking any more risk than Griffin. In other words, they both have taken on the same company-specific risk, but Delanie has come out ahead.

Delanie's Option B will always provide for a greater net income than Griffin's scenario for the same amount of risk.

Of course, it would have been more prudent for Delanie to invest the money she would have used to exercise the options in assets *other* than her company stock, in order to diversify the personal capital and investment capital risk. Even if these other assets underperform the company stock, she would end up ahead, and with less risk. Remember that in Option A, the company stock had an annual average return of 15.31% over that time period, while the alternative investment had an annual average return of only 2.48%, and yet Delanie and Griffin ended up with the same net amount. A side-by-side comparison of these scenarios can be examined in Table 1.

The two scenarios imply that the best course of action is to wait to exercise stock options, but that is true only if you do not address the diversification issue. However, the lack of diversification can be very costly, and the net value of the potential free money must be balanced against this cost.

TIMING: THE REAL ISSUE

The bottom line is: Once you exercise your options, you should also cash out of the stock and diversify your capital.

However, the real issue concerns the decision as to when to exercise the options. The more the stock increases in value, the greater the free money, but also the greater the risk to your capital. If something should suddenly happen to the company, you could be out of a job and your stock options would be worth substantially less, if they are worth anything at all.

The older you are, and the larger the options represent as a percentage of your investment capital, the

TABLE 1. EXERCISING STOCK OPTIONS: COMPARING SCENARIOS

	Griffin	Delanie Option A	Delanie Option B
Date Options Vest: Year 0			
Exercise Price	\$10	\$10	\$10
Fair market value at vest date & exercise date	\$15		\$15
Out-of-Pocket Costs on Vesting Date			
Exercise stock (\$10 × 1,000)	\$10,000		
Income taxes (\$15 – \$10) × 1,000 × 31% tax	\$1,550		
Invest in a tax-free money market fund		\$11,550	
Buy LCM on open market (\$15 × 770)			\$11,550
Total Out-of-Pocket Costs	\$11,550	\$11,550	\$11,550
<i>Current Holdings</i>			
No. of shares of LCM with a \$15 cost basis	1,000		770
No. of shares of LCM with option to buy at \$10		1,000	1,000
No. of shares (\$1/share) in tax-free money market acct.		11,550	
Cash Out: Year 3			
Fair market value of LCM (annualized return 15.31%)	\$23	\$23	\$23
Gross value of LCM after sale	\$23,000		\$17,710
Less capital gains tax: 20% of [(\$23 – \$15) × # shares]	\$1,600		\$1,232
Net Value of Stock Holdings	\$21,400		\$16,478
Net Value of Money Market Account		\$12,440	
<i>"Cashless" Exercise of Options</i>			
Gross value of options (\$23 × 1,000)		\$23,000	\$23,000
Cost to exercise the options (\$10 × 1,000)		\$10,000	\$10,000
Income taxes (\$23 – \$10) × 1,000 × 31% tax		\$4,030	\$4,030
Net Value of "Cashless" Sale		\$8,970	\$8,970
Total Net Value After all Sales and Taxes	\$21,400	\$21,410	\$25,448

greater the risk. Additionally, the longer you hold the options, the lower the net free money amount relative to alternative investment options. This is a factor of the free money being taxed as earned income, while alternative investments can have the preferable long-term capital gains tax rate.

Unless there is some major event in the future for the company, one that is not already priced into the value of the stock, a prudent course of action is to periodically exercise your options, sell the stock, and invest the net proceeds in a diversified portfolio.

Since you have the ability to control when you exercise your options, you should look at your tax consequences year-by-year, and

attempt to set up a liquidation schedule that is best for your taxes, and is not based on attempting to time the market value of your company's stock.

It should also be kept in mind that this article is intended as a general overview of some of the issues surrounding compensatory stock options. There are other tax strategies that can be used to help maximize the profits of stock options, but they can be very complicated and are unique to each individual's total financial picture. Because of the large amounts of money involved, as well as the complicated tax issues, it is highly recommended that you consider consulting a tax specialist when putting together a cash-out strategy. ♦