Sweetgum Labs

Insights

Good Work, You Made It. Now Work Harder!

Employers must retain talent to remain competitive and to maintain a functioning business. Compensation departments address this need for retention by recognizing highly valued employees and awarding them the option or the right to their employers' stock.
There are several different types of stock awards that corporations implement with varying nuances to hit the achieves status. Stock award recipients are typically excited to receive this award but generally unprepared to maximize the utility of it.

"Can I exercise my options" he said.

Unfortunately, at 4PM they expired worthless.

“It was 4:10PM eastern time on a Friday at a major investment bank’s ESOP (Employee Stock Ownership Plan) department. I was sitting at my desk when one of the executives from a company I was assigned called me: “Can I exercise my options” he said. The executive had an option that was worth $225,000 as of the morning. Unfortunately, at 4PM they expired worthless (despite the fact the stock was up that day.) ***I didn’t know what to say.*** *We had tried contacting him numerous times in the prior weeks but the phone number and email address on file were no longer connected or attended to. Upon learning this news, he angrily hung up to call his corporations benefits team.*
I’ve seen this situation play out before (on a much smaller scale), he had lost it all. His benefit team confirmed this terrible news and that was his new reality. “

John Baranauskas
CERTIFIED FINANCIAL PLANNER™
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It’s important to note that rules and expirations differ between ESOP’s plans so only use this as a guide and NOT gospel. For example, plans can allow for vesting after termination (fully vest the options upon separation but typically need to exercise them within 90 days), but most do not. Some employee-friendly plans allow for workers to retain them in retirement while others need to be strategically divested before giving separation notice. The policy is written by your HR department so always read the plan description BEFORE making a status change and be careful what you say (separation, retirement or if you sense that you are about to get let go.)

You have the right to purchase the full quantity of stock options but in order to purchase you need to cover the grant price (if 100 options are awarded at $10 a share and currently trading at $15 you will need to pay for the $10 purchase price in order to maintain 100 shares.) People normally dislike coming out of pocket; therefore, most participants end up selling the option and either taking the cash or converting the proceeds into shares (after taxes and cost are deducted.) The options themselves are taxed at regular income (at the time of exercise), but any gains going forward on the remaining shares (if you elect to keep them) are at your capital gains rate.

Restricted Stock Unit's (RSU's) are taxed upon vesting while stock options are taxed upon exercise. An 83(b) election allows the participant to recognize the taxes immediately following the grant (to circumvent future appreciation liability) but has the risk of overpayment if the share price drops. If you are in the retirement red zone (5 years before retiring) you will want to coordinate exercising the options to coincide with the optimal tax year (if you can keep the options it may make sense to wait until you are retired if you expect income to drop enough to put you in a lower bracket.)

Many participants in ESOP's end up accumulating a very high concentration (as a percentage of overall assets) of corporate stock. Familiarity and belief in the corporate mission makes it convenient to keep It invested where it is. The task of reducing concentration risk is often hampered by the pending tax burden and a heuristic approach many participants implement when expiration is near, and action is required.

Steps you should take.

1 Seek help if you sense that you are in over your head- a planner will be best for full context but a review with your HR documents and the plan administrator can be useful as well.

2 Keep an eye on expirations, stock prices and tax changes- they all can affect this as plan awards typically span numerous years. Mark your calendars!

3 Structure a plan to divest as concentration risk become apparent- it is problematic to work for the company with most of your assets invested in it (think Enron.)

4 Don't get emotional- options leverage the upside of common stock and volatility can quickly erase large percentages of your gains (Retrain your brain to not think long term in this situation, think of when the expiration is coming due.)

5 Below are a couple of articles we have found helpful to get folks familiar with the terminology and taxation options. Enjoy!

https://blog.wealthfront.com/always-file-your-83b/

https://www.forbes.com/sites/davidrae/2018/09/04/your-employee-stock-options/#3c1455492e6e

Defitintion of Terms can be found on the back page.

Financial planning has *evolved.*

The 83(b) election is a provision under the Internal Revenue Code (IRC) that gives an employee, or startup founder, the option to pay taxes on the total fair market value of restricted stock at the time of granting.

An employee stock ownership plan (ESOP) is an employee benefit plan that gives workers ownership interest in the company.

A restricted stock unit (RSU) is a form of compensation issued by an employer to an employee in the form of company shares.

This Outlook should not be construed as research or comprehensive investment advice nor should it be considered an offer or solicitation to buy or sell any security or participate in any specific investment strategy. There is no guarantee that any forecasts or opinions will be realized.
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