# BATTLESHIP AND “THE TORTOISE AND THE HARE”:

## What they can teach us about Stock Options and Deferred Compensation Plans

2024

Prepared By :

**Matthew Daugherty**

CEO of Balanced Wealth Group

www.choosebalance.com

**In this paper, we will explain why we love advising and empowering professionals with equity compensation.** We'll provide perspective on why managing risk can be so important in equity compensation plans, and provide strategies for doing so. We'll also discuss the differences between different types of equity comp and provide possible strategies for determining how to get more out of these plans from a risk and tax perspective. There are several equity compensation plans and strategies that are not discussed in this article, so it should not be considered comprehensive.

---

## How this came to be

I was 23 years old when I met "Bob and Candace" in 2002. Bob was an executive at a large company, and he'd amassed a sizeable amount of assets in his 401(k) plan and company stock via Stock Options he had earned throughout the 90s boom. I was fresh out of college, and daunted by the task of convincing Bob and Candace that I was the right person to provide them with financial guidance. Fortunately, what I lacked in experience, I made up for in drive to do the right thing. At the time, I worked under a management system that pushed me to sell products to my clients. However, I could quickly see that Bob was looking for guidance, not to be sold.

Bob and Candace became the first of many executives I would go on to work with, and decades later, we still have a wonderful relationship. In many cases, executives like Bob are what our industry considers "dreaded" clients, because their engineering backgrounds make them unshy about asking questions. They want to understand the numbers behind the recommendations. I'm grateful to have worked with clients like Bob and Candace in my early days, because I had to learn how to ask the right questions to better understand the client and their specific needs. I had to learn how to give advice, instead of just selling. And, I had to learn how to properly monetize a system like that so I could stay in business. Working with these people is what helped me to become the advisor I am today.

**So many executives do nothing with their plans since they don't know how doing something will affect their cash flow, taxes, investment returns, risk level and goals.**

With so many different equity compensation plans available to many employees and executives, my practice has made it our mission to help professionals make more confident financial decisions that will help to simplify their lives, reduce stress and pursue financial freedom. So many executives do nothing with their plans since they don't know how doing something will affect their cash flow, taxes, investment returns, risk level and goals. We provide a collaborative advisory experience, prioritizing empowering action and doing the right thing.

## Historical perspective of risk, and why this is so important

While a company's bankruptcy is not a common risk, it is a large risk. Familiarity bias is one of the greatest risk factors employees and executives face when investing in their company's stock. Naturally, it is the company they know more about than any other.

When bankruptcy happens, many executives face a hat-trick of risk: losing their annual income, devaluation and worthlessness of stock, and assets in their Non-Qualified Deferred Compensation (NQDC) plans becoming subject to the claims of creditors, even if they are invested in a diversified portfolio of mutual funds (and employees in these plans stand behind the banks and other creditors in line for payout).The smaller, but much more prevalent risk is that of stock price volatility and decline. The Russell 3000 is an index similar to the S&P 500, but includes 6x the number of companies. Since 1980, 40% of the companies that have been included in this index have lost at least 70% of their value, without recovery (that's well in excess of 1,200 of the largest US companies, as it has turned over many companies over the years). Some companies make it, some don't—but all experience volatility. This article will discuss systems to better balance and manage the risks of equity compensation.

Many executives find it highly unlikely that their companies will ever be at risk of filing bankruptcy, but the history books prove otherwise. From 1995 until 2006, Lehman Brothers grew to be the fourth largest investment bank (1) in the country. Its stock price greatly outperformed the S&P 500 in every year except one. It provided its investors with superior returns, outperforming the S&P by 20% or more in five of those twelve years, and even outperforming it by 72.67% in 1999. It also lost far less than the S&P during the Dotcom bubble. (8)

When executives have stock in a company that continually outperforms the overall market in this way, it can be very difficult to convince them to sell or even diversify that stock. In September of 2008, Lehman Brothers filed for bankruptcy, resulting in stock price dropping 99.96% that year. It did not become worthless, however, but grew 173.68% the next year. (Don't get too excited by that rally. If an investor loses 99.96% on a $100 stock, it drops to $0.04. Earning 173.68% on a stock worth $.04 only grows it to be worth $0.4695). Lehman Brothers stock officially became worthless in 2012. Nonetheless, over these four years, Lehman Brothers sold off many of their operations and closed 80 of its smaller subsidiaries, leaving many employees with worthless stock AND looking for new jobs. (1)

Currently, the largest company by market cap in the United States is Apple. Unsurprisingly, investors love Apple! But that doesn't mean it has always been fun to own, for price-sensitive investors. During the Dot com bubble, it lost over 80% of its value. During the great recession of 2008, it lost over 58% of its value. From September of 2012 until July of 2014, during a period of increasing revenues and profits, its stock price did not increase (fortunately, it had started paying dividends by that time). Obviously, to this point, Apple has "survived".

Such a large US company could never file bankruptcy, right? Not so guaranteed. For many years, this same title was held by General Motors. GM certainly did not become such a large company by breaking even, or being a non-worthy stock to invest in. Nor did it do so on the heels of poor-performing executive teams. Still, in June 2009, the company filed bankruptcy. Investors who owned stock in the company found themselves empty handed. When new shares were reissued in the company, existing stockholders were required to buy those if they wanted back in. Similarly Chrysler, one of GM's larger competitors, preceded them in bankruptcy in April of the same year.

In the GM example, NQDC plan participants only received approximately one-third of their assets in the plan. In the Chrysler example, the same participants received **nothing**, even after long drawn out legal battles. The IRS established the Internal Revenue Code section 409A in 2004, which requires plans to restrict early withdrawals—so even if plan participants had known what was about to happen, they were restricted from withdrawing funds from their NQDC plans, regardless of penalty.

---

Let's look at another example: energy. Many people believe that energy companies are insulated against hard times, as we always pay our electric bills. However, when environments change, or executives get greedy, it can happen—just as it did to Pacific Gas and Electric Co in April of 2001 and Enron in December of 2001; the former due to increased energy costs and limited generating capacity, and the latter due to a now-familiar corporate scandal.

Many people know what happened to Enron, but not what led up to it. From 1996 through 2001, Enron was considered the darling of Wall Street, being named "America's Most Innovative Company" by Fortune magazine six years in a row. Its stock price more than doubled over three years, jumping from under $20 per share in 1997 to $90 per share in October of 2000. (3) Enron employees were becoming multi-millionaires, not just in their stock plans, but also in their stock-saturated 401(k)s. (6)

These same multimillionaires became job seekers with no retirement savings when all those shares that they refused to sell became worthless.

In Enron's time, there were less restrictive rules against withdrawing from NQDC plans, and many executives began immediately withdrawing assets from the plan to try to protect themselves, even though it meant paying income tax (but no tax penalty). This left many current and ex-employees with no assets to draw on, as those who got into the plan first liquidated it. The previously mentioned Internal Revenue Code section 409A was established in 2004 to discourage participant withdrawals, in response to this.

In January of 1995, before many people were buying Microsoft stock, it was worth less than $4 per share.That grew to over $57 in December of 1999 (over 1,400%)! However, many investors bought the stock between 1998 and 1999 (with the attitude that what has been going up, can't go down). Those investors would have had to hold the stock for 14 years before they saw it grow in value again. Today, Microsoft has completely shifted from granting Stock Options to granting Restricted Stocks.

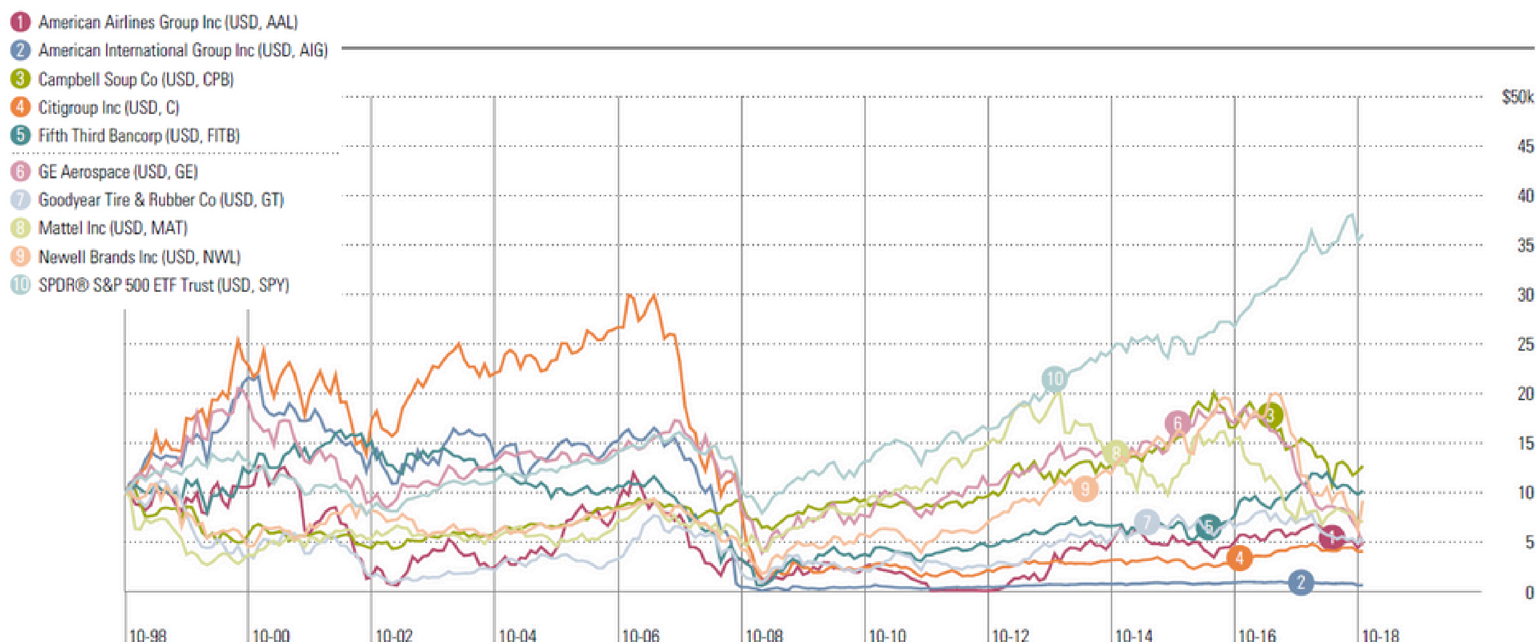
One of the best roller coaster rides investors have taken over the last two decades is Netflix. It lost over 80% of its value in 2011 and 2012, 40% in 2018, 30% in 2019, and over 70% again in 2021 and '22. Granted, had an investor bought $10,000 worth of Netflix at the beginning of 2015, it would be worth approximately $130,000 today. But rather than experiencing linear growth, it would have first skyrocketed to $140,000, then plummeted to $37,000, before eventually settling where it is today.

When we look back with 20/20 vision, we think that it should have been easy to spot these fluctuations in advance. It's easy to say things like, "I never would have sold Netflix." But investors who saw $140,000 drop to $37,000 didn't find it so easy to hold on.

**For investors who can stomach the largest roller coasters, this paid off.**

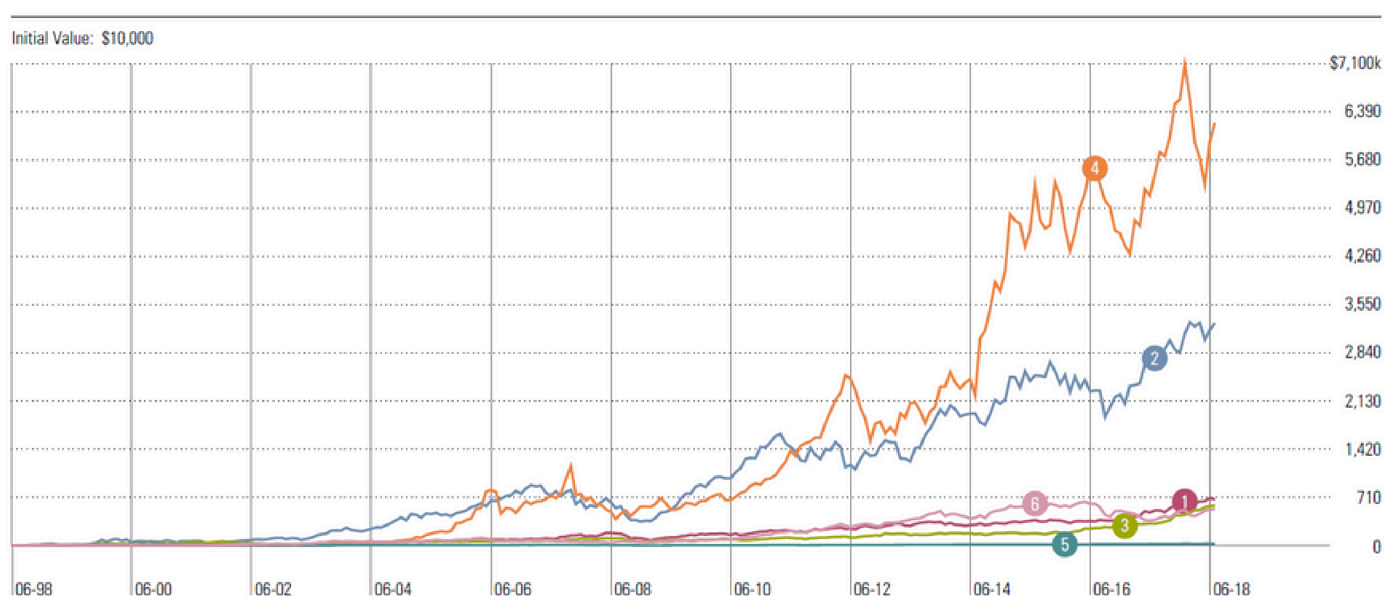
What do the names Monster Beverage, Cognizant Technology, Tractor Supply Company, Ansys Inc, Abiomed Inc, Arista Networks, Copart, and Kansas City Southern have in common? How about AIG, Citigroup, Goodyear Tire and Rubber, Newell Rubbermaid, General Electric, Mattel, Fifth Third Bancorp, CBS Corp, Campbell Soup Co, and American Airlines Group?

## Prominent businesses with poorly performing stocks 1998-2018



Aside from the energy drink, many people have never even heard of the companies in the first group; meanwhile, the latter group is full of household names. However, buzz can be deceiving—the former group of lesser-known names represent some of the best performing stocks in the S&P 500 from 1998 to 2018. The latter, familiar group represented some of the worst performing stocks in the S&P 500 over the same time frame. (7)

## Less recognizable businesses with thriving stocks 1998-2018




| Investment | Cumulative Return % (Net of Fees) | Annualized Return % (Net of Fees) | Amount at End of Period $ (Net of Fees) |
|---|---|---|---|
| 1 Ansys Inc (USD, ANSS) | 6,740.01 | 23.42 | 684,001.41 |
| 2 Cognizant Technology Solutions Corp Class A (USD, CTSH) | 32,680.90 | 33.43 | 3,278,089.58 |
| 3 Copart Inc (USD, CPRT) | 5,854.86 | 22.57 | 595,486.35 |
| 4 Monster Beverage Corp (USD, MNST) | 62,177.54 | 37.76 | 6,227,754.23 |
| 5 SPDR® S&P 500 ETF Trust (USD, SPY) | 257.04 | 6.54 | 35,703.85 |
| 6 Tractor Supply Co (USD, TSCO) | 5,361.94 | 22.04 | 546,193.89 |

Consider today's "darling" of Wall Street: Nvidia. Everyone wants a piece. Investors could first buy their stock in 1999. Adjusted for splits, the stock traded for less than $10 for 17 years, until 2016. It proceeded to rise to over $300 per share in 2021, at which time it lost over 60% of its value, before it began its rise to its current fame in October of 2022. For investors who can stomach the largest roller coasters, this paid off. But most can't. And, for employees with Stock Options in Nvidia, there would have been very little return for most of its tenure.

No one can predict the future, and no one knows when these things will happen. The issue is that human investment decisions tend to be made more from emotion than logic, and the two dominant emotions when it comes to money are fear and greed. Stock catastrophe often happens to companies that no one ever believes it could happen to—especially the employees working on the inside. It is hard for us to sell what is making us more money than any of our friends and neighbors are making in their diversified portfolios. But sometimes, that greed takes us from our homes—our neighbors and their "boring portfolios" waving us goodbye.

## How can executives properly balance risk with their plans?

**Step one – Build your Battleships (Diversify)**

Consider the game Battleship. Many of us played it as children. Each player starts with one Aircaft Carrier, two Battleships, three Cruisers, four Submarines and five Destroyers. Just like the US Navy, there are different types of Battleships, not just one. And, just like the Navy, anyone who was any good at the game knew that they had to SPREAD OUT their battleships or risk having them more easily destroyed. Would any Battleship player, or the Navy for that matter, put their full faith and confidence in one Aircraft carrier based on the premise that it is the largest and most powerful? Of course not. One torpedo could take it out, regardless of its size. But one torpedo cannot take out a strategically placed fleet. When investing for our goals, there are many tools at our disposal, and diversification (or spreading out) our investments allows us to help mitigate common risks. Unfortunately, with investing, people are too often caught up in getting ahead faster than anyone else, and therefore seem to be more willing to take undue risks.

Going back to the specific examples of Lehman Brothers and Enron, the risk that many employees and executives of these companies faced was that of overconcentration in company stock. The problem wasn't investing in the stock; it was investing too much in the stock, and not enough elsewhere. This created an "all battleships in one part of the grid" situation. Employees allowing emotions to influence their investing decisions saw the ability to earn more in a position that to them seemed to be less risky because of familiarity bias. As humans, we tend to trust who and what we know, and we'll look past logical risk as a result of that trust. Why is this? Often it is because we fear change in our lives. Other times it is because of peer pressure and fearing what others will think. If we don't invest as much in company stock as our peers and it happens to take off, our friends and coworkers may be living lavish lifestyles, while we're left behind.

Additionally, in some environments, there is a fear that our superiors will wonder if we're really team players. I have worked with countless executives who have used this excuse. They don't want to sell their stock because they fear it will make them look bad in the eyes of upper management. We fear looking bad if we're wrong, but if everyone else is wrong, then that risk goes away. We can be pressured to make disadvantageous decisions as part of a community.

**I caution those who may be section 16 insiders:** if and when you sell company stock, there are investors out there watching who will make known their criticisms, even accusing you of lacking confidence in your company (despite knowing absolutely nothing of why you actually sold). And of course, some of us are more easily persuaded than others—even when we know deep down that a decision is a poor one.

**I am not suggesting that one should not invest in their company stock. To the contrary, taking advantage of company stock and stock awards received can be a huge catalyst in achieving financial freedom.**
**What I am suggesting is that one should invest prudently in that stock, and in a way that aligns with their goals and values.**

My recommendation is to hold no more than 10% to 20% of one's investable assets in any one company, especially when other areas of our financial lives (i.e. our salary) depend on the same company. (Interestingly enough, the Aircraft Carrier makes up 30% of the targets on a Battleship board.) In addition to having a percentage rule to follow, it is advisable to consider how much in dollar terms that 10% to 20% represents. Many high-level, C-suite executives have minimum hold requirements and, in some cases, are forced to hold a higher percentage than is advisable; however, even in these cases, there are risk mitigation strategies at our disposal, which I will detail below.

Two questions should always be asked when deciding whether or not to sell company stock. These are:

1. If I didn't work at this company, how much of their stock would I own in my portfolio?

   and

2. If I had "x" number of dollars in cash, would I use it all to buy stock only in my company?

Many find that the answers to these questions contradict their current strategy.

In summary, the first step any investor should consider when making decisions about their company stock is to set a limit on how much they are willing to risk in their own company's stock.

We often advise our clients to hold no more than 10% in their company, unless of course they have a minimum hold requirement. If a client has more than 10% in company stock stock, we pivot the focus to discussing tax efficient strategies to help reduce their exposure and diversify their assets.

---

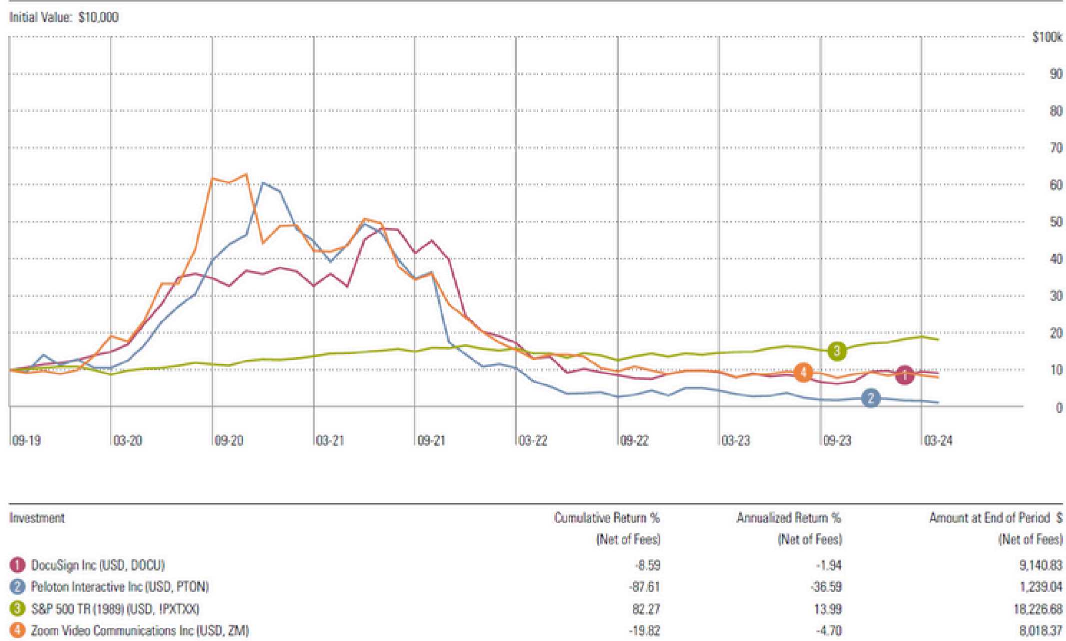
**Step two – Pick your Poison (What to sell, and when)**

Many executives will hold several different types of stock: common stock positions in a brokerage account, common stock positions in an employee stock purchase plan (ESPP), company stock funds in their 401(k), Stock Options, Restricted Stock, Performance Units or stock in their NQDC plan (complicated, right)?! Every single one of these comes with different tax and risk consequences when sold or exercised. So, "pick your poison," but pick carefully, know the consequences, and have a plan.

Aside from the tax and risk consequences, it is important to consider timing. Almost every discussion I have with clients holding stock awards comes down to not wanting to sell now and "miss out" on what is on the horizon. Not to mention, many articles you read on Stock Options state that Options contracts will achieve a greater value if held until end of term. This advice assumes stock price will continue to rise over that period—a bold assumption! When determining whether to hold or sell stock, emotion should be taken out of the equation. "The only people who nail the bottom of a market downturn are liars and lottery winners." (4) This quote applies to those selling company stock and trying to determine the best time to sell as well.

Take the emotion out of the decision. Once the percentage threshold that was set is reached, then stock should be sold or options exercised, without thinking about what could be on the horizon. I began writing this article as the COVID-19 virus was gripping the world in fear. As a result of the times, many of the world's prominent companies saw their stock prices drop substantially. This was an eye-opening event that many did not predict. Four years since, many companies have survived; some have already closed their doors; still others will not survive the changes forced onto us by those unprecedented times. Importantly for executives, many companies' stocks could still be damaged for years to come. The average recession keeps stock prices down for 18 months. Buying the "right" stock is one thing. Knowing when to sell it is a completely different game. Just ask those who bought DocuSign, Zoom, and Peloton (and take a look at their stock charts).

## DocuSign, Zoom, and Peloton during Covid-19 Crisis




| Investment | Cumulative Return % (Net of Fees) | Annualized Return % (Net of Fees) | Amount at End of Period $ (Net of Fees) |
|---|---|---|---|
| 1 DocuSign Inc (USD, DOCU) | -8.59 | -1.94 | 9,140.83 |
| 2 Peloton Interactive Inc (USD, PTON) | -87.61 | -36.59 | 1,239.04 |
| 3 S&P 500 TR (1989) (USD, IPXTXX) | 82.27 | 13.99 | 18,226.68 |
| 4 Zoom Video Communications Inc (USD, ZM) | -19.82 | -4.70 | 8,018.37 |

During the Covid pandemic, a high-ranking executive at a publicly traded company said to me, “I always wondered why anyone would exercise their stock options before the expiration date. Now I know.”

This person had 2,500 stock options that were set to expire on April 9th of 2020. The options had a value of $62,000 on January 1, 2020, and by March 20th, were worth $6,500. By April 9th, when they were set to expire, she was forced to exercise them at a value of $24,000. Had markets stayed down longer, as they typically do during times of recession, this individual may have received little to nothing from that award she had waited 10 years to receive. Comparatively, if she had sold 18 months before expiration (when her time value had basically expired) she would have received $53,500 in value!

Once you’ve made the decision to sell, you must decide which shares to sell, and from which plan. For now, we will discuss two strategies to consider.

## Market Fluctuation October 2018 - October 2020

This article only touches on some of the intricacies of only three types of plans. Specific decisions should never be made without a high level of knowledge about each plan or the guidance of a financial or tax professional who specializes in this area.

## Strategy One: The Tortoise and the Hare

For the purposes of this article, we will focus on two specific strategies that can be utilized to manage risk through viewing different equity compensation plans holistically, instead of separately. We'll use the metaphor of the children's story "The Tortoise and the Hare" to explore these strategies and their impacts.

Many executives receiving equity compensation receive it in at least two forms: Restricted Stock **(the Tortoise)** and Employee Stock Options **(the Hare)**. Restricted Stock and Stock Options are not of equal value when issued to employees, nor when they are sold or exercised due to the tax consequences. The relationship between these two plans is important to consider holistically to maximize benefit.

### Differences between Options and Restricted Stock

**Stock Options** have a limited duration, and often must be executed quickly to maximize value. They only have value once the stock has appreciated above the strike price and the holder has exercised the option to purchase, making them essentially worthless at the time they are granted. If the stock price drops below the strike price and never recovers before they expire, Options can become worthless (consider Microsoft). However, as stock prices rise more often than they fall, Options utilize leverage in the form of the strike price. This operates almost as an interest-free loan from the company that does not have to be paid back if the stock price drops below it. If an employee has an Option with a strike price of $50 and the current stock value is $100, the company is essentially offering a $50, interest free loan to the employee that only must be paid when the employee exercises. If the stock appreciates to $110, the value of the stock increases by 10% ($10/$100). However, the exercisable VALUE of an Option in this scenario increases by 20%, as it appreciates from $50 to $60 ($10/$50). Options require more effort than stock, due to the need to monitor the strike price, expiration and intrinsic value. For Options holders, it is more of a race than a marathon, making it **the Hare** in our story. Options can appreciate an award faster than stock, and have more value the more volatile the stock is.

**Restricted stock** is not as "sexy" as Options, but is far more reliable. In the case of Restricted Stock Units, "slow and steady wins the race," which makes it our **Tortoise**. It has value right away, or when vested, the market value of the shares (think of this as a bonus paid in stock). Many employees, regardless of status, receive cash bonuses every year, but very few employees turn right around and use that cash bonus to buy company stock. Alternatively, very few employees receiving Restricted stock turn around and sell the shares immediately when they vest, even if this is a prudent strategy. As Restricted Stock vests, it becomes traditional stock, typically held in a brokerage account. At this point, it can be treated like any other stock and sold at any time, or held indefinitely. Once Restricted Stock vests, it is very common for an executive to "sit on it," since she doesn't have to worry any longer about monitoring the Strike Price, the expiration date, or the possibility of losing them all together. During periods of low volatility or poor stock performance, RSUs tend to win the race.

**How do I decide whether I want to exercise options or sell stock?**

This analogy in no way suggests that one should only be a Tortoise and never the Hare. At least four things should be considered holistically:

1. The outlook and volatility of the stock and the markets in general
2. The different options available to exercise awards
3. Time until expiration
4. Taxation

Understanding the historic volatility of the overall stock market is a powerful tool to making investment decisions. If a client is extremely bullish on their company stock and the markets in general, it is typically more beneficial to hold onto Options, while selling stock. Alternatively, if the stock and the markets are at all-time highs, and have been for several years, it may be prudent to consider holding stocks, while exercising Options. The volatility of the stock and its industry must also be considered. Consumer Discretionary stocks and Technology stocks tend to be much more volatile than health care stocks and utilities, and volatility makes Options contracts more valuable.

Over the last 50 years, there have been 10 stock market corrections in excess of 20% from peak to trough and 30 corrections in excess of 10%. Of those, only five lasted between 16 and 20 months. Only one, the dot com bubble from 2000 to 2003, lasted longer (almost 30 months). If we know that the average correction lasts 18 months and we know we have Options expiring during that time, then the prudent decision is to exercise any Options that have a value and expire during that period. This takes emotion out of the decision-making process. (Remember, only liars and lottery winners time it right!)

The second thing to consider is the Award Agreements and in what ways executives are allowed to exercise their Options. There are Cashless, Sell to Cover, Exercise and Hold and Stock Swap options, to name a few. Depending on what the Agreement specifies, cash may be required to exercise options. It is also possible that shares of stock already owned in other forms can be used to exercise Options. In most cases, companies provide the ability to exercise awards without paying in.

The third thing to consider is how much time a client has before Options expire. Certainly, if the Options contracts will expire within the year, then it is almost certain that they should be exercised so that they don't expire worthless. Many, but not all, companies have tools in place to automatically exercise options at expiration; consult your Options agreement. Executives should always know when their Options expire and whether they are required to execute the transaction. We have seen executives let Options expire, not realizing they are sacrificing any value they had.

The fourth thing to consider is taxation. Tax consequences for selling stock are often less than that of exercising Options. If Restricted Stock has vested and the employee who earned them has held the stock at least one year after vesting, the gain in the stock should be treated as capital gains and taxed at a maximum rate of 23.8%. (7) Options, assuming they are Non-Qualified Options (Incentive Stock Options (ISOs) are taxed differently, and should be approached differently) treat any value received as employment income taxed at the client's ordinary federal marginal tax rate, which can be as high as 37%, and subject to Social Security (if not capped), Medicare, State and Local taxes (if applicable). This amount taxed as wage income is also the amount of basis in the stock, and will need to be tracked by the shareholder. If the Vested Restricted Stock has little to no gain, or potentially a loss, it is possible it can be sold with no tax consequences or even tax benefits.

When considering Options, imagine the Hare stopping just before the finish line for his meeting with the IRS. One should always consult their tax professional before selling or exercising to review the tax consequences, and it is never recommended to decide strictly based on the tax consequences. The tax tail should never wag the dog.

**Case Study**

Let's get back to Bob and Candace. Bob is an executive at MKVED Corp, and the couple's total investable assets equal $3,000,000. This includes a jointly owned non-retirement investment account valued at $500,000, two 401(k) plans valued at $1,500,000, and $1,000,000 in stock awards from his company. The stock awards are broken down as follows:

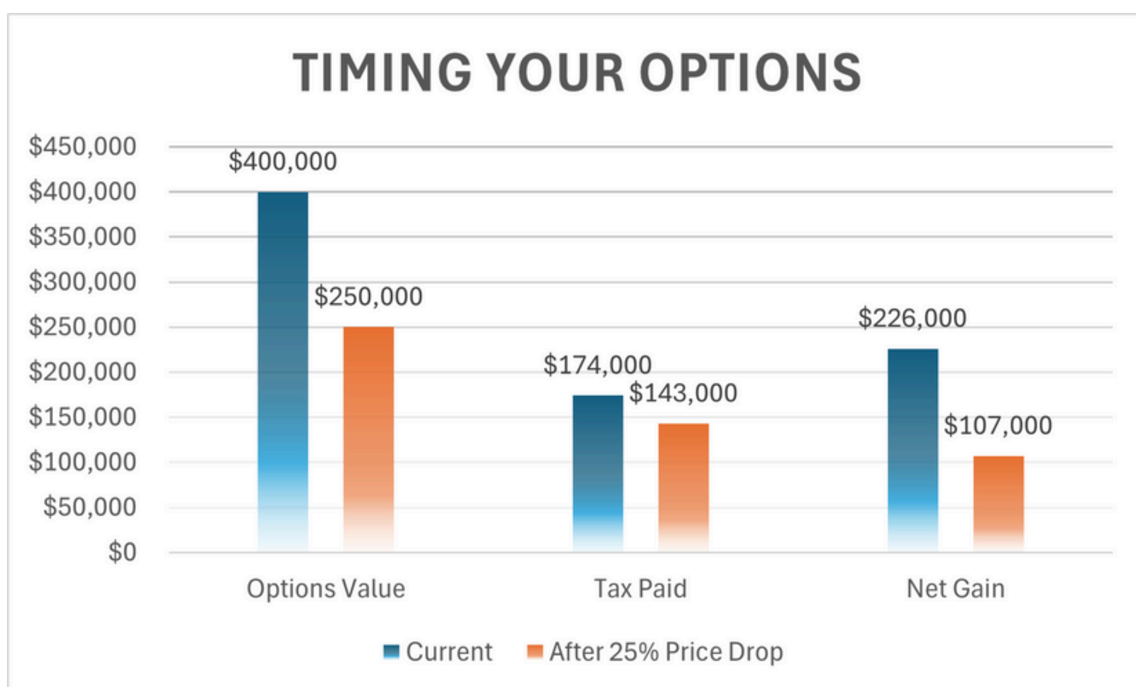
- 5,000 Vested Shares at $100 / share, which Bob paid tax at vesting at $50 / share over one year ago
- 10,000 Exercisable Options with a Strike Price of $50 and a current stock price of $100

In this example, Bob's company stock value equals 33% of his investable assets; the stock has continued to appreciate at a rate much greater than the S&P 500 over the last five years. Bob is hesitant to sell based on recent performance, but together, Bob and Candace prudently decide to reduce their exposure in his company to 20%, meaning they'll have to reduce the position by $400,000. This can be achieved by selling 4,000 shares of stock, 8,000 Options, or a combination of the two.

Since Bob has equal value in Vested Stock and Exercisable Options, the couple is uncertain as to how to proceed. Bob does not want to exercise his Options, because he knows that the leverage they provide will produce a greater percentage return if the stock price continues to rise. Candace is more concerned that the percentage of loss is greater with the Options than with the stock. She's also concerned that the overall markets are at all-time highs, and worries that a major stock market correction could make many, if not all, of his Options worthless, knowing that what goes up must come down.

Like many client couples, Bob and Candace view risk differently from one another. In this scenario, Bob decides to follow Candace's prudence and agrees to begin exercising his Options instead of selling his stock. He realizes this is best, considering the recent run up in stock price, the stock market being at an all-time high, and the fact that the majority of his Options are set to expire within five years. Still, it's a difficult decision—many of Bob's coworkers argue that Options should always be held until expiration to take advantage of the leverage. With support of the Apple and Microsoft stories quoted above by his advisor, Bob was convinced to minimize his risk.

MKVED provided Bob with a Cashless Exercise option, so he could execute the transaction without bringing any shares or cash to the table. He then received cash for his shares, which he was immediately able to reinvest into a diversified portfolio.



Fortunately, Bob and Candace worked with their advisors to understand possible tax consequences, so there were no surprises at tax time. They were able to properly pay in the taxes that came due. Exercising Options cost Bob and Candace approximately $118,000 more in taxes in the current year than selling stock. (8) However, they understood that the tax would have to be paid at some point. They decided they would rather pay $174,000 in taxes on $400,000 today, netting them $226,000, than take the risk they would only net $107,000 on a $250,000 sale if the price dropped 25% at a period just before expiration, when they would be forced to exercise.

If Bob had been retiring the next year with reduced income and the ability to maintain his Options into retirement, different considerations would have to be made. This is why it's important to consult an individual client's Options agreement. If circumstances had been different for Bob, he may have been better off waiting to exercise in years when his income is expected to be lower, which would allow the Options to be exercised at a lower tax rate.

One common mistake executives make is under-withholding for taxes on Options exercises and vesting stock. Most companies will not withhold the actual amount of tax due on an exercise or vest, instead withholding at the IRS-issued supplemental tax rate of 22%. This can often leave a large tax due at tax time. Bob's Federal income tax on his Options exercise is estimated to be $145,000. If MKVED used the supplemental rate for withholding, they would only withhold $88,000, leaving a $57,000 tax due. Many people plan to use company bonuses to cover these taxes each year, but this is a dangerous strategy when bonuses are not guaranteed. Careful planning can ensure that executives aren't hit with unwelcome surprises like this at tax time. Executives should work with their financial advisors or tax professionals to determine a plan to pay the taxes and avoid penalties from the IRS.

Bob and Candace did not make their decision based on emotions or financial figures. While they worked with their advisors to consider the financial impacts of stock and options, they used logic not only to maximize their returns, but also to minimize risk. This conservative, intentional approach ensured that while they may not have ended up with the most in the end if all went well, they also wouldn't have been left in the dust if things had gone poorly..

**A twist in the planning**

Let's now assume that Bob's company stock has underperformed the overall markets over the last five years. The market is nine months into a correction and down 30% from its highs overall. Bob's stock is now at $55 per share, so his Options still have value—just a lot less.

Bob thinks he should exercise his Options.  The stock hasn't been a great performer, which tells him he won't really be able to take advantage of the leverage side of the equation. He's also very concerned with the markets being down, and worries that his Options will become worthless.

Bob's financial advisor reminds him that the total value of stock he holds is now only $325,000, representing just 14% of his total investable assets. His long-term goal had been to reduce company holdings to below 20%, which he achieved. He is concerned that he may have Options that will expire worthless, but doesn't want to exercise them at such a low value. When Bob and his advisor review the MKVED Equity and Incentive Plan document, they determine that Bob is allowed to use existing shares of stock to exercise his Options.  They decide to use 1,818 shares of his existing stock to exercise the 2,000 Options that will expire within the next year, allowing him to walk away with 182 additional shares and 8,000 Options still on the table. This strategy also limits Bob's tax bill for the year, because delivering the 1,818 shares to settle the option is not a taxable event. Therefore, the shares that otherwise would have been sold to pay taxes can instead continue to compound. Tax will have to be paid on the stock at some point, but this approach allows them to keep more funds invested for the recovery. This strategy is designed to balance risk with return potential, not based solely on taxes or potential future growth.

**Summary of strategy one**

In summary, here are four things one should consider in deciding how to exercise company holdings:

1. The overall percentage of company stock owned.
2. Risk and tax consequences of selling stock vs exercising Options in different plans. (It's important to note that taxation on the sale of RSUs differs from the sale of stock in an ESPP, a 401(k), an ESOP or a Deferred Compensation plan, so this needs to be considered as well.)
3. Options expiry timeline, in re: current and expected status of the stock, the markets, and the economy in general.
4. Review Award Agreements to understand how Options can be exercised.

---

## Strategy Two – "The old Switcheroo": Stock, Options, and Deferred Compensation plans

Many companies offer Non-Qualified Deferred Compensation plans as a benefit to high earning employees and executives. This provides the option to defer compensation that is not currently needed, and is helpful for those who want to save more than the IRS 401(k) limit, while keeping their tax bill low. Most NQDC plans allow for the deferral of up to 75% of salary and 100% of bonuses, and many offer a matching program, so they can be very attractive.

However, there are risks. One risk is that the decision to defer is made in the year prior to the actual deferrals and can NOT be changed! The second risk was briefly mentioned earlier in this article: these plans are unsecured, and the assets in them are essentially a loan to the company, with a promise to pay in the future that is not guaranteed.

> **Non-Qualified Deferred Compensation plans are unsecured plans, and the assets in them are essentially a loan to the company, with a promise to pay in the future that is *not guaranteed*. In the event of bankruptcy, it is highly likely that these assets will be forfeited.**

In the event of bankruptcy, it is highly likely that these assets will be forfeited. (Do not fret, as this is NOT the case in a 401(k) plan.)

Another often-overlooked factor is that funds in NQDC plans **cannot** be rolled over to IRAs in the future. They **will** be taxable upon distribution. Also, the distribution date typically cannot be changed once elected. In cases when it can be changed, the timeline of receipt is delayed for an average of five years.

There are two primary strategies that many consider for using NQDC plans. The first is for executives who already hold substantial assets in an NQDC plan, and either want to maintain a high level of stock, or are required to. This strategy considers what happens to stock holdings, as well as assets in NQDC plans, in the event of bankruptcy.

If an employee has $500,000 invested in a diversified portfolio in their NQDC plan and $500,000 in company stock outside of the plan (i.e. vested Restricted Stocks, or those from an ESPP), they are taking on twice as much risk as necessary. This is because in the event of the company's bankruptcy, the employee will likely lose $1,000,000: the entire value of the stock as well as the funds in NQDC plan.

If, instead, the employee sells all his vested stock shares and diversifies those into a portfolio of funds or other stocks, and then turns around and sells the funds in the NQDC plan to buy $500,000 worth of stock in his NQDC plan, he only loses $500,000 during a potential bankruptcy. In this scenario, neither his stock holdings nor the diversification of his portfolio changes. He simply shifts where he owns the stock and where he owns the other assets, effectively reducing his risk by 50%. This is what we call "the Switcheroo".

The second strategy is for executives who hold substantial stock awards via Options, and/or vested stock that is highly appreciated. Often, executives want to sell portions of their stock, but do not do so for fear of the associated tax bill. Many elect to defer income into their NQDC plan in the coming year, knowing that they will supplement that income from the sale of stock or the exercise of Options, and they can keep their tax bill equal to what it would have been by deferring salary or bonus income.

Anyone who is a section 16 insider must carefully consider plans like these, and be aware of Short Swing Profit rules to make sure stock is not being purchased for less than what it was sold for within a six month period on both sides of the transaction.

**Case Study**

In our example above, Bob's employment income from salary and bonuses totaled $500,000. If he and Candace agreed in October of 2020 to exercise his Options, but wait until January 1st to do so, he could have chosen to defer $400,000 of his salary and bonus into his NQDC plan. In this scenario, they still pay taxes on the exercise of the Options, but because he deferred much of his other income, he doesn't pay any more than he would have if he never deferred his compensation and exercised options. And, because his other income was lower, he only pays $140,000 in taxes on the Options exercise, compared with $174,000 in the previous example (saving them $34,000 in taxes in that year). Assuming Bob and Candace do need their income to live, they would place the proceeds from the exercise into a High Yield Savings account immediately after exercise and pay themselves bi-weekly from the account.

There are several risks to this strategy. The first and most important being is that they must commit to it before knowing what the actual value of Bob's Options will be on January 1st. In the event of a catastrophe, Bob's Options could become worthless before that date. So, before electing this strategy, an employee would need to make sure they have adequate reserves in other places to meet their spending needs for the year. Secondly, by the end of the year, Bob and Candace will have $400,000 in an NQDC plan that is unsecured, and they will not be able to access it until the time that Bob specified he would have it distributed. Consequently, this strategy typically only works if the income is deferred until a period such as retirement, when other income sources will be low.

As always, we must consider timing. In this scenario, Bob and Candace will be taking $400,000 out of investments in a lump sum up front (the Option exercise) and reinvesting over time (via contributions to the NQDC), which puts them at risk of missing out on compound interest. However, this would work IN their favor IF markets declined over the year. In their case, it is worth that risk to properly diversify their portfolio. Let's also not forget that they can invest the $34,000 of tax savings at the beginning of the year.

**Summary of strategy two**

There are inherent risks with Non-Qualified Deferred Compensation plans that must be considered before utilizing them. However, if used properly, these plans can help to reduce risks for executives with substantial stock holdings, and can also help to manage taxes over a lifetime.

**Conclusion**

As financial advisors specializing in executive benefits, we have seen a lot! We've seen executives have Options expire worthless. We've seen executives exercise Options, incur more tax than necessary and lose leverage, when they should have sold stock with no tax consequences to pay for their new kitchen. We've seen executives get large, unexpected tax bills, or pay taxes twice on the same income due to reporting mistakes. We've seen executives plan to pay their tax bill with their expected March bonus, only to see that bonus not paid out. We've seen executives get criticized, both privately and publicly, for not having enough perceived confidence in their companies. We've executives lose awards at separation or retirement because of poor planning. And the list goes on. Take the time to learn more about the complicated benefits packages available to you, and arm yourself with the knowledge to get more out of them!

As always, I will remind you that none of these strategies should be used without careful consideration of all the risks and rewards, and financial and tax professionals should be consulted. Every equity compensation plan comes with some form of legal agreement that is signed by the executive and by the company. Reviewing these documents before signing is imperative, but reading them is even more important before making any decisions with these plans.

This article only discusses three of the many types of equity compensation, and two of the strategies often utilized. Professionals with access to equity compensation plans should always establish a goals-based plan for making any decisions with their plans and before implementing any strategies. For anyone who lacks the knowledge and the confidence to do this on their own, there are equity professionals out there who can help.

Balanced Wealth Group
www.choosebalance.com

Disclosure:

The situation presented in this scenario is not specific to any certain client scenario but has been based upon experience with many clients and is fictitious in nature. Please note this example may not be suitable for all, and you should check with your financial planner about your specific situation. The information provided is for educational and informational purposes only and does not constitute investment advice and it should not be relied on as such. It should not be considered a solicitation to buy or an offer to sell a security. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. You should consult your attorney, tax advisor, and/or your financial professional prior to making changes to your portfolio or strategy. The views expressed in this commentary are subject to change based on market and other conditions. These documents may contain certain statements that may be deemed forward-looking statements. Please note that any such statements are not guarantees of any future performance and actual results or developments may differ materially from those projected. Any projections, market outlooks, or estimates are based upon certain assumptions and should not be construed as indicative of actual events that will occur. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. All investments include a risk of loss that clients should be prepared to bear. The principal risks of our strategies are disclosed in the publicly available Form ADV Part 2A.

Balanced Wealth Group LLC ("BWG") is a registered investment advisor. Advisory services are only offered to clients or prospective clients where BWG and its representatives are properly licensed or exempt from licensure. For additional information, please visit our website at https://choosebalance.com.

Supporting Documentation

1https://archive.fortune.com/galleries/2009/fortune/0905/gallery.largest_bankruptcies.fortune/10.html

2Lehman Brothers Holdings, Inc. (LEH) Yearly Returns, www.1stock1.com

8https://www.britannica.com/event/Enron-scandal

3https://www.begintoinvest.com/enron-stock-chart/

4What If You Buy Stocks Too Early During a Market Crash?, Ben Carlson, www.awealthofcommonsense.com

6https://www.barchart.com/stocks/indices/sp/sp500?
viewName=performance&orderBy=percentChange1y&orderDir=desc&page=all – ENRON and Chrysler Bankruptcies

7https://seekingalpha.com/article/4208570-best-and-worst-performing-stocks-in-s-and-p-500-over-last-20-years-and-how-performed-in-2018 (TO SEE COMPANIES THAT PERFORMED POORLY OVER THE LAST 20 YEARS)

6In September of 2008, I worked with clients that we will call Corey and Shelley.Each had Stock Options in their respective companies. Shelley's Options had been granted to her in 2003 and 2004, when the company's stock price was approximately $43 and $46 respectively. Their "plan" had been the same as most executives; to hold until expiration. The stock price hit $54 within a year of the initial grant, and the options had a value of approximately $20,000 (but were not exercised). In the story, the Hare ran fast and furious, got a big lead and then "relaxed". After hitting $54, the stock "relaxed" and then dropped below the strike price and did not recover until near the time of expiration. The 2003 Options expired worthless and Shelley was able to squeeze out about $2,500 from the 2004 grant. Even with a strategy, it is possible that Shelley would have lost Options, but, had they paid more attention and had a plan to exercise over the course of her Options tenure, she may have gotten more value out of them.

7 Based on the Internal Revenue Code, as amended, through May 2021. Includes the 20% rate on long-term capital gains and the 3.8% surtax on net investment income.

8Using Naviplan financial planning software, and assuming a $500,000 salary for Bob under 2020 tax laws, it was estimated that their total tax due (if living in the state of Ohio) would be approximately $153,000 without any stock changes. The estimated total tax due upon selling $400,000 worth of stock at $100 with a $50 cost basis was approximately $209,000 and the estimated total tax due upon exercising $400,000 worth of Options at $100 with a $50 strike price was approximately $327,000