Weighing Your Options

By John Nersesian, CIMA®, CPWA®, CIS, CFP®

Employee stock options can be difficult to understand for many investors. Clients need your help to manage them effectively. Like having a corner office and access to the corporate jet, employee stock options were viewed as a status symbol during the 1990s bull market. They were offered to a group of employees as an opportunity to create significant wealth quickly. From a company’s viewpoint, stock options could attract and retain valuable employees without using cash, which was often in limited supply for start-ups.

But the bear market of 2000 to 2002 sent the S&P 500 tumbling by more than 40 percent. Many technology shares evaporated, wiping out paper profits for employees who failed to grasp the two-sided nature of the instruments: reward and risk.

Then in 2005, the Financial Accounting Standards Board (FASB) passed a stricter rule regarding how options were reported. FASB 123R required companies to begin expensing options from earnings. Previously, the cost of issuing stock options had to be disclosed only in the footnotes of financial statements, and it wasn’t directly deducted from the net income reported to investors.

With options having a bigger effect on financial statements, companies were expected to begin changing their compensation strategies. Then the banking crisis hit in 2008 and the markets fell dramatically through early 2009. Grants of stock options never quite rebounded after the change in accounting rules and the global financial crisis. Companies started offering more restricted shares instead of options. A report by Equilar found the percentage of the S&P 1500 that granted options fell by 68 percent from 2010 to 2014, while the use of restricted stock increased 15 percent.¹

Although stock options have fallen from the pedestal they were on in the 1990s, they continue to have a meaningful role. Clients often need education and advice in dealing with options. Grant documents are packed with details written in legalese and involve complicated tax consequences and a seemingly endless number of possible exercise strategies. (See sidebar for stock option terms and concepts.)

This creates a great opportunity for financial planners to help clients avoid option pitfalls. If they exercise too early, they miss out on appreciation potential. If they wait to exercise until the options are just about to expire, they may lose the chance to sell at a better price and the opportunity to do tax planning. Moreover, clients often don’t see the role options play in their overall portfolio asset allocation. Finally, without proper advice, clients could let their options expire without ever exercising them.

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PSYCHOLOGICAL FACTORS

Financial planners shouldn’t underestimate the psychological factors that influence when and how clients exercise stock options. Often, when they receive their option grants, clients will come up with a value for the stock that they think is “fair.” Behavioral finance experts call this a “reference point.” It could be based on how...
much the client needs to achieve a certain goal, a past stock price, or one that has been suggested by an analyst. This point guides the client’s decision about what to do regardless of what the market considers a fair value for the stock.

Many investors also find it difficult to be objective about their own firm’s stock. It’s hard for them to separate their sense of loyalty to the company from their feelings about the stock, a condition known as “familiarity bias.”

Here are some open-ended questions to help you understand a client’s frame of reference and option objectives:

- What’s your view of your company stock? How have you come to that view?
- How do you see your role in your company changing?
- What is your primary objective for these assets (tax minimization, appreciation, risk reduction)?
- What will these assets be used for in your financial plan (retirement, business, charitable)?
- Describe your strategy for your option holdings.
- Which would make you more upset: selling shares before a significant advance, or holding shares and suffering a significant decline?

### NSOs AND ISOs

The primary types of options are non-qualified stock options (NSOs) and incentive stock options (ISOs). NSOs are more common, often distributed to the majority of eligible employees, and ISOs typically are issued only to senior level executives. ISOs are more limited because they don’t give the firm a deductible expense at the time of exercise (see table 1).

The Internal Revenue Service (IRS) also limits the maximum value of ISOs that option holders can exercise: No more than $100,000 in stock (valued at the time of the grant) may become exercisable for the first time in any one year subject to the company’s vesting schedule. Vesting schedules vary,
but there are typically two types: cliff vesting, where all options vest at once, and step or graduated vesting, where a percentage of options vest each year. Any amount over the $100,000 limit is treated as an NSO.

With NSOs, employees aren’t liable for taxes at the time of the grant. NSOs are fully taxed at ordinary income rates on the bargain element (the difference between the fair market value and the grant price at the time of the exercise), whether the shares are sold immediately or held for future appreciation.

ISOs provide potential tax benefits. If clients hold their positions for at least two years from the date of the grant and the stock shares for one year from the date of the exercise before selling (referred to as a qualifying disposition), no income tax is due at exercise. Instead, the gain is treated at more favorable long-term capital gains rates when the underlying security is sold.

This strategy provides some pluses, but it exposes the option holder to additional risks. Clients may experience downside price volatility in the exercised but unsold holdings as they wait out the holding period. And although the bargain element is not taxed at ordinary rates at exercise, it is considered a preference item when calculating the investor’s alternative minimum tax (AMT) liability.

**THE AMT TRAP**

AMT originally was designed to keep wealthy taxpayers from using loopholes to avoid paying taxes. However, unlike the traditional tax code, AMT wasn’t originally indexed for inflation, which meant more taxpayers were becoming subject to AMT as compensation rose. Congress passed annual “patches” to address this until it passed a permanent patch in January 2013.

One factor that can trigger AMT liability is timing-related income items including the ISO bargain element at the time of exercise. The AMT caught many technology company option holders who exercised ISOs in the early 2000s, then watched the price of the stock decline dramatically. They still were required to report the bargain element for purposes of calculating AMT income, leading to a significant tax liability on a less valuable asset.

In this situation, a useful strategy could be to forgo the qualifying disposition requirements and sell the stock before the end of the one-year holding period (in the same tax year as it is exercised). The option would then become non-qualified, and the bargain element would be taxed as ordinary income. This provides the individual with funds to pay the taxes (which wouldn’t be available if the client held the stock for the required period and later had AMT liability).

**BASIC STRATEGIES**

Selecting an appropriate strategy for handling options requires a clear understanding of a client’s objectives. Investors who are looking to create immediate liquidity or to reduce their exposure to company stock may want to exercise and sell. This is done most often using a “cashless exercise,” where the investor’s brokerage firm lends the investor the required capital to exercise the options (buy the shares at the exercise price) and simultaneously sells the shares at the fair market value, providing the investor with immediate liquidity equal to the bargain element minus transactions costs.

“Exercise and hold” may be a better strategy for investors who are bullish on their company stock and want to accumulate wealth. The investor would

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**Figure 1**

**A COMPARISON OF OPTION TYPES (NSOs)**

<table>
<thead>
<tr>
<th>Grant 4/1/2013</th>
<th>Exercise 2/1/2016</th>
<th>Sell 3/1/2017</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BARGAIN ELEMENT</strong></td>
<td><strong>CAPITAL GAIN</strong></td>
<td><strong>Sale Price:</strong> $40</td>
</tr>
<tr>
<td>Realize $20 Ordinary Income for 2016</td>
<td>Realize $30 Long-Term Capital Gain for 2017</td>
<td>FMV at Exercise: $30</td>
</tr>
<tr>
<td>Exercise Price: $10</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Hypothetical examples for illustrative purposes only. There can be no assurance that an investment will provide positive performance over any period of time. An investor could lose money. Tax rates and IRS regulations are subject to change at any time, which could materially affect the results of this analysis. Clients should consult their professional advisors before making any tax or investment decisions.

Sources: Adapted from the CPWA curriculum, IRS
commit capital to exercise the options and then hold the underlying shares for added appreciation. For NSOs, ordinary income taxes would be due on the bargain element at exercise, but any additional gains may be taxed at long-term capital gains rates when the shares are sold if they have been held for more than 12 months. ISOs would not generate an ordinary income tax liability at exercise, but they would create AMT preference income.

**Figure 2**

A COMPARISON OF OPTION TYPES (ISOs)

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Sources: Adapted from the CPWA curriculum, IRS

### Table 2

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Planning Objective</th>
<th>What’s Involved/Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Diversification</strong></td>
<td>Exercise and sell (cashless) or partial “sell to cover”</td>
<td>Portfolio diversification; finance option exercise with proceeds of stock sale. For ISOs, this is considered disqualifying disposition and they are treated as NSOs. “Sell to cover” involves selling only enough options to pay exercise price and taxes.</td>
</tr>
<tr>
<td><strong>Wealth Accumulation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exercise through stock swap (see “Stock Swaps” section)</td>
<td>Eliminate need to sell stock. If owned stock is sold to pay for exercise, potential capital gains liability. Continue to hold stock from options with no cash outlay. Plan must provide for this. Use owned stock to pay exercise price (vs. cash). Will have to pay ordinary income tax on compensation income. Some plans provide for reload feature, which replaces options exercised through swap.</td>
<td></td>
</tr>
<tr>
<td>Exercise and hold</td>
<td>Continue to participate in appreciation of stock price; secure capital gains taxation for appreciation. Need source of funds to pay exercise price and taxes (NSOs) or potential AMT (ISOs).</td>
<td></td>
</tr>
<tr>
<td><strong>Tax Minimization</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exercise before vesting with 83(b) election (see “The 83(b) Election” section)</td>
<td>Cap potential AMT exposure (ISOs); limit reported income (and tax) at exercise (NSOs); start capital gains holding period early. Determine if plan allows early exercise; file 83(b) within 30 days of exercise.</td>
<td></td>
</tr>
<tr>
<td>Exercise ISOs and use proceeds from subsequent sale in following year to pay AMT if needed</td>
<td>Finance payment of AMT liability (due in year 2) with sale of stock while retaining ISO one-year holding period. Timely exercise of ISOs in first quarter of year 1 to meet holding period before sale in first quarter of year 2 to pay taxes; assumes stock appreciates.</td>
<td></td>
</tr>
<tr>
<td>Tandem exercise of ISOs and NSOs</td>
<td>Minimize potential AMT liability Potential AMT liability on bargain element from exercise of ISOs is balanced by higher compensation income from exercise of NSOs.</td>
<td></td>
</tr>
<tr>
<td>Gifting of options</td>
<td>Remove options from estate; create gifts with future appreciation potential. Only available for NSOs (if plan permits); if gifted before vesting, value of gift undetermined until vesting.</td>
<td></td>
</tr>
<tr>
<td>Exercise options (NSOs), sell and establish grantor charitable lead trust</td>
<td>Reduce income tax due in year of exercise; fulfill philanthropic desires. Cashless exercise to exercise NSOs, sell stock. Tax on options is offset by potential charitable deduction. Donor (option holder) liable for tax on trust earnings in subsequent years.</td>
<td></td>
</tr>
</tbody>
</table>

**TAX IMPLICATIONS: NSOs**
The exercise price of $10 establishes the floor value of the option. The fair market value at exercise caps the bargain element and determines how much ordinary income will be taxed in the year of exercise (see figure 1).

**TAX IMPLICATIONS: ISOs**
The exercise price of $10 again sets the floor for the option, which is exercised at a fair market value of $30, producing a bargain element of $20. The bargain element is not taxed, but it is considered income for determining AMT liability. If the stock is held for at least a year after exercise and at least two years from the grant date, it will qualify for long-term capital gain treatment when it’s sold using the exercise price as the basis (see figure 2).
STOCK SWAPS

Yet another strategy is a stock swap or pyramiding, in which clients use company stock they already own to fund the exercise of new shares. This way the investor doesn’t have to sell shares and pay capital gains to get the funds to exercise the option. (The bargain element is still immediately taxable, however, so clients will need to cover the withholding and taxes, and the capital gains tax eventually will be due when the shares acquired in the swap are sold.) Table 2 provides a summary of various stock-swapping strategies that may be available to your client.

Another advantage of a swap is that after exercise the investor gets back two lots of stock, one with a low basis and one with a high basis, which offers financial planning flexibility. Thirdly, the company may provide a reload feature, granting the client new options to replace the shares used to fund the exercise. A swap also could be appropriate for clients whose firms encourage pyramiding, in which clients use company stock they already own to fund the exercise of new shares. This way the investor doesn’t have to sell shares and pay capital gains to get the funds to exercise the option. (The bargain element is still immediately taxable, however, so clients will need to cover the withholding and taxes, and the capital gains tax eventually will be due when the shares acquired in the swap are sold.) Table 2 provides a summary of various stock-swapping strategies that may be available to your client.

The following hypothetical example illustrates the benefits of this swap strategy (see Table 3).

- A client owns shares of company stock with a basis of $10 that currently trades at $50 a share.
- The client also has 1,000 NSOs with an exercise price of $25 for a total cost exercise of $25,000.
- The client can “pay” the exercise price by using 500 shares of the stock already owned (500 x $50 = $25,000).
- The client receives 500 “exchange” shares with a $10 basis and 500 “new” shares with a $50 basis.
- If the plan provides for a reload feature, the client also can receive 500 new options (to replace the 500 shares used to fund the exercise) with a $50 exercise price. Investors bullish on their company stock can lock in their profits (the company shares exchanged) and participate in future appreciation through a stock swap.

THE 83(B) ELECTION

Clients who expect their company stock to appreciate may want to exercise their options early to convert that appreciation, which would be taxed as ordinary income, to capital gains. To do so, they must use an 83(b) election to exercise their options before vesting and start the capital gain holding period sooner. In the case of an NSO, early exercise converts ordinary income liability to the lower capital gains treatment. In the case of ISOs, early exercise reduces the bargain element and therefore the associated AMT preference income, making it less likely that the investor will fall into the AMT.

For example, a client receives options at a $10 exercise price for a stock worth $40 at that time, the long-term capital gains rate would apply to $25 worth of appreciation per share. What would happen if the client waited for the three-year vesting period to exercise? The entire bargain element of $30 a share ($40 minus the $10 basis) would be subject to ordinary income.

One critical point about early exercise is that the client still must wait for the vesting period to end to sell. If the client leaves the company before this happens, the client may have paid the tax for no economic value. Another pitfall is that the stock price may not rise or it may even decline in value. So, clients need to carefully weigh the potential tax benefits of an 83(b) election against the significant risks.

CONCLUSION

Although no longer the dominant form of long-term equity award, stock options still remain a viable and popular form of executive compensation. The complex financial and tax-related ramifications of various strategies often confuse, if not paralyze, clients in making decisions.
Advisors who develop expertise in this area can attract and retain significant relationships with executives. John Nersesian, CIMA®, CPWA®, CFP®, is head of advisor education at PIMCO and former chair of the Investments & Wealth Institute. He teaches in the CPWA executive education program at the University of Chicago Booth School of Business. He earned a BS in business and economics from Lehigh University. Contact him at john.nersesian@pimco.com.

ENDNOTE

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