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Three Things Executives Often Miss in Maximizing Their Stock Based Compensation

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Nothing is more expensive than a missed opportunity.
-H. Jackson Brown, Jr.

Employer stock based compensation has been an important wealth-building tool for many executives. The landscape has changed significantly in the past few years yet, the type and scope remain an important tool that should be managed effectively. Over the years we have seen common mistakes made that could be avoided with some forethought and planning.

Waiting until expiry to exercise. Believe it or not some options that are in the money expire without being exercised. "North of 10% of valuable options expire un-exercised every year," says Bruce Brumberg, editor of myStockOptions.com, a site devoted to options, restricted stock, and other forms of equity-based compensation.

Executives get busy and their focus on other business and personal items that cause them to often “space out” that there is an option that needs to be dealt with. All options should be placed into a management system to avoid this unfortunate, but all too easy, event to occur.

Not having an exit strategy is all too common and sometimes leads to waiting until the last minute to exercise. In some cases this is due to not having a strategy to determine when the optimum price and time to maximize the value of the option is. There are tools such as Black-Scholes models that can assist in determining an appropriate time to exercise. Black Scholes uses the current price, the stocks volatility and time to expiry to assist in coming up with a fair value. While not perfect it is far better than moistening one's finger and holding it up to see which way the wind is blowing.

Not understanding the tax consequences of the options ranks at the top of the list for missing optimum results. Executive Stock options fall into three general types: Incentive Stock Options, Non-Qualified Stock Options and Stock Grants. Each of them has their own unique and special tax features.

Incentive Stock Options (ISO's) have been waning in popularity in very large organizations, but are still popular in many start up/emerging companies. ISO's have a special feature, when you exercise the tax event is deferred until the stock is actually sold. For example, ABC Company issues a stock option for $10 per share and the current value is $20. When the executive exercises the $10 gain, it is not recognized until the ABC Company stock is sold and converted to cash. If the executive holds for one year and one day, the exercised stock's gain then qualifies for Long Term Capital Gains treatment, at a maximum of 20% instead of a potential maximum ordinary income tax at a maximum 39.6% plus any state taxes. This is a huge differential. In many cases executives are not aware of the difference, exercise the stock and sell immediately, losing the Long Term Capital Gains treatment.

Non-Qualified Stock Options (NSO's)

While ISO's have been declining in popularity over the last few years NSO's have been increasing. The overall costs due to the tax treatment for the issuing company are lower due to the tax treatment at exercise for the company. Let's look at another example using the same scenario as before. ABC issues an NSO at $10 per share; there is no tax to the executive at the time of issue. The stock appreciates to $20 and is vested. The executive decides to sell at $20 and the gain is $10.00. The stock is either purchased with cash or (the most common) a zero cost exercise is affected that in effect sells and provides the executive with the same $10. All of the $10 is taxed as ordinary income for employment compensation.

In exercising an additional step needs to be taken for tax planning purposes. While, for IRS purposes the gain is taxed as compensation, in most cases the withholding is not based on the combination of the executive's salary and the NSO sale, resulting in the April 15th surprise that no one wants. Proper consultation with your financial and tax advisors when exercising is critical to understanding what will be required. Stock Grants are gaining more and more traction in corporate America, in part, because of the increased pressure on compensation by shareholders.

Stock Grants lack the leverage that ISO's and NSO's enjoy, and in many ways, are like a deferred bonus with upside and/or downside potential. For example, ABC Company issues an executive 1,000 shares of stock at a price of $10 per share. No taxes are due at the time of the grant since the stock has a vesting schedule (typically) and the taxable event occurs when the stock is fully available to sell. Whether or not the stock is sold there will be a taxable event when the shares vest either partially or fully. The challenge may be in having the cash to pay the tax that matches up with the vesting date. Let's assume the stock doubles to $20 and vests. The taxable income would be the full value of the stock or $20,000. If, on the other hand, the stock drops to $5 the taxable income would be $5,000. The only way the stock can have Long Term Capital Gains treatment is to hold one year and one day past the VESTING date.

There is one exception called an 83(b) election. By filing an 83(b) election you are declaring the value of the stock grant at the time of grant rather than waiting. If, in the example above, the stock doubles to $20 and an 83(b) election was properly filed within 30 days of the initial grant the tax treatment would be $10,000 of ordinary income in the year of the grant and $10,000 of Long Term Capital Gain when the stock is ultimately sold. Of course there are disadvantages to this strategy/election. One being the executive could end up forfeiting the stock pre-vesting and, the other being the stock may not appreciate and the tax treatment would be worse than waiting. If the confidence is very high and the executive feels very confident in the long-term role at the company then an 83(b) election is something to seriously consider.

Stock Based Compensation is an excellent tool in building personal wealth. Attention must be paid to the management of these tools and the timeliness and techniques that are most appropriate. By paying attention to the expiry dates, types of grants and the tax treatment executives can maximize the impact on their personal financial security.
