

In Their Own Words: Financial Advisors On Company Stock Strategy For Year-End 2008 And The Market Downturn

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It is an understatement to say that 2008 was a tough year for stock markets, your company's stock, and the value of your outstanding stock grants. The market drop, combined with the likelihood of tax-rate changes ahead under President-Elect Obama, gives you some different factors and issues to consider in year-end financial planning for 2008 than you had in prior years.

We asked financial advisors around the United States for their ideas on planning for both year-end and beyond as the market downturn plays out. Below are their responses, presented in their own words.

Lee McGowan

*TFC Financial Management
Boston, Massachusetts*

The turbulent market conditions and unstable economic environment have given more reasons to plan for year-end and prepare for the years ahead. It is time for investors to take a step away from their investment account statements, from television's talking heads and market prognosticators. It is time for investors to gather their wealth management team in order to assess all aspects of their financial plan and focus on their goals and objectives. Along those lines, a thoughtful and proactive client contacted me recently to discuss his investment strategies, including his restricted stock and nonqualified stock options in the context of his overall financial plan.

- **Wait to exercise NQSOs**
- **Manage risk instead of making assumptions about future prices**
- **Offset gains with losses**

The client has been diversifying out of his restricted stock and nonqualified stock options for the past few years and has enjoyed tremendous upside. This year, the client realized more than \$2 million in capital gains from his restricted stock sales. He also has a significant cash position. Unfortunately, the client's remaining restricted stock and options, and other equity investments, have dropped recently along with the market. The client asked a question: "Should I be exercising more options since the stock price has fallen?"

The client was prepared to exercise his options by selling shares to cover the cost (cashless exercise) or pay cash for the cost of the options. He is bullish on his stock long-term and would like to understand if there is a benefit to exercising the options and holding the shares. His CPA, Dennis LaPorte of UHY Advisors, and I discussed the issue and each analyzed various scenarios.

Dennis LaPorte ran scenarios based on a cashless exercise using future assumptions of stock price and tax rates. Does it make sense to exercise options via a cashless exercise and hold the stock (paying tax at capital gains rates rather than exercising and paying ordinary income tax rates on future appreciation)? He found that, despite the difference in ordinary income tax rates and capital gains rates, it makes sense that the client should not exercise the options and hold the stock.

I ran scenarios based on the client paying cash for the option cost (including income tax). After reviewing the client's overall investment portfolio and cash needs (for living expenses and a new business venture), I advised the client against exercising his options and holding the stock due to the leverage advantage of the options, his liquidity needs, and the diversification benefits of holding cash (versus using the cash to exercise his options).

I shared the following simplistic scenarios with the client to exaggerate the point:

Scenario 1: Pay \$2 million in option cost to exercise the options, and the stock goes to \$0. If the stock goes to \$0, then he has lost his \$2 million cash investment and the options are worthless.

Scenario 2: Take no action, and the stock goes to \$0. If no action is taken, he maintains his liquidity and diversification (reducing his equity market risk). His options are worthless, but he has maintained his \$2 million cash position.

The client was satisfied with the advice from his wealth management team to preserve his liquidity and maintain his investment diversification while taking advantage of the leverage in his stock options. We did not show him additional illustrations of the long-term consequences of the potential transaction. At this point, given current market conditions and the client's needs, it was important to manage the investment risk and discount assumptions about his company's future stock price.

In addition, the client has \$2 million in realized capital gains from his company restricted stock transactions this

calendar year. We are working through a tax-loss realization program to offset as much of the gain as possible. The losses in the portfolio are unfortunate, but as [another article](#) on this website mentions, we must turn the lemons into lemonade.

Richard Friedman

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Albany, New York*

Obviously, everyone is different: age, family situation, cash-flow needs, proximity to [retirement](#), investment risk profile, income tax, and needs for estate planning. Hopefully, you have listened to your financial advisor and are properly diversified in your investments according to your risk profile. That should have included planning for a "doomsday" situation (which some people have now actually gone through: company stock becoming almost worthless, or the company declaring bankruptcy).

When the market in general, or your company stock specifically, is in a free-fall, it often is not the best time to take drastic action (like sell everything). If you have adopted a stock option strategy, you should generally stick to it. But the doomsday scenario might have included a provision that if the stock price fell to a certain target, then certain options would be exercised and the [stock sold](#). (Of course, insiders and certain others always need to pre-clear any transactions.) That prompts the need to always be aware of corporate policies about transactions involving company stock: not only when sales (or purchases) can take place, but whether the company allows [hedging](#) (typically no for insiders) or margining company stock (a mixed bag based on our preliminary review of written company policies).

Most companies have [ownership requirements](#) for executives, and many have stock retention policies. Executives should generally not necessarily buy company stock to meet guidelines that are a multiple of pay without determining whether the company intends to modify the guidelines to account for an extraordinary and largely unexpected drop in stock price. (There are better ways to establish guidelines than a multiple of salary, as companies that have these guidelines will discover.) Companies may modify their policies or may provide a longer timeframe to meet targets.

Stock price drops may be viewed by some as buying opportunities. However, it is open-market purchases that are most likely to lead to inadvertent [Section 16\(b\) violations](#) (we saw a number of clients in this unintended situation recently). Not only do [insiders](#) have to be extremely careful here, but all individuals have to consider the [wash sale rules](#), if they sold the same security within 30 days at a loss to "harvest" capital losses (definitely a major tax-planning tool this year).

Company stock exposure is not limited to options and [restricted stock](#), but also takes into account stock held in a [401\(k\) plan](#), stock units under a deferred compensation plan, and shares bought in an [employee stock purchase plan](#) (ESPP). The deferred compensation has a double-whammy risk because of the security danger if the company goes bankrupt. Any asset-allocation review should consider stock holdings here. The advantage of moving stock into another investment choice in these plans, or into [IRAs](#), is that it can be done tax-free (though, again, it generally would need to be pre-cleared for an insider). [ESPPs](#) can be an opportunity, especially if there is a discount in the purchase price. (You need to review the exact terms of the plan to see whether it has a discount and a lookback provision.)

Income tax planning often takes place at [year-end](#). That can include:

- [tax-loss harvesting](#) (mentioned above)
- [charitable gifts](#) of appreciated securities (may have less stock in that situation this year)
- minimizing the [alternative minimum tax](#) (more taxpayers had AMT last year; the rules have changed somewhat for this year)

Here's where an exercise of nonqualified stock options can make sense: to increase taxable income. In contrast, an exercise of incentive stock options (ISOs) needs to be considered in light of the AMT (there are some new rules for ISOs and new reporting rules for employers on ISOs and ESPPs).

On the estate-planning front, clients may be considering funding [GRATs](#) with company stock. We have heard that the IRS is considering closing down zeroed-out GRATs, so this needs to be reviewed with sophisticated counsel.

Scott Barbee

*Truepoint Capital
Cincinnati, Ohio*

- **Consider a doomsday scenario**
- **Know restrictions on sale**
- **Price drops can be good times to buy company shares (just be aware of tax and SEC rules)**
- **Review company stock exposure**
- **Consider harvesting losses, minimizing AMT, making gifts, or even forming a GRAT**

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As every client situation is different, specific recommendations should be made by a competent professional who has a complete understanding of the client's circumstances. That said, there are some basic strategies everyone should consider.

- Selling [concentrated company stock positions](#) when possible, even if it means recognizing substantial capital gains. Actively harvesting the rest of the diversified portfolio for capital losses to offset those gains can go a long way to reducing the tax bill.
- Selling concentrated company stock positions that have been held more than one year even if there aren't losses to offset the recognized gains. At 15%, the long-term capital gains tax rate is low. At least for the near future, the rate will certainly not be lower than it is now. And though the potential increase to long-term capital gains rates under the new presidential administration may have to be placed on hold until the economy rights itself, a future increase is still a threat. But be mindful of the potential impact of AMT.
- In circumstances where clients may still have some room in the 15% ordinary income tax bracket, don't overlook the possibility of recognizing gains to [take advantage of the 0% capital gains rate](#) which applies to that bracket.
- Assuming financial circumstances permit, continuing a regular plan of annual exclusion gifting of stock to family members affords clients the opportunity to move more shares to them than in recent years, without necessarily worrying about transfer tax issues. With a rebound in that stock, more appreciation could be shifted to those family members.

- **Sell concentrated positions**
- **Harvest losses from other holdings**
- **Consider GRATs.**

Under the right circumstances, clients can consider a more involved strategy, such as creating a [grantor-retained annuity trust](#) (GRAT) to shift future appreciation to other family members with little or no immediate transfer tax cost. If the expectations for the company are high, but the current company stock price is significantly depressed, a GRAT may provide a tremendous opportunity to transfer wealth. The current low-interest-rate environment also enhances the attractiveness of executing a GRAT currently.

John Lawson

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Executives may wish to re-examine existing [Rule 10b5-1 plans](#) in light of recent dramatic declines in the price of employer stock. Plans set up when the stock was selling at multiples of current levels and showing good upside may well have lost any connection to current reality and projections. Consider canceling current plans, or waiting for current plans to expire; then, after an appropriate wait (60–90 days), establish a new plan based on the new level and outlook. Be sure to check with employers about their individual policies on cancellation, waiting periods, the establishment of new plans only during windows, and share ownership requirements.

- **Re-evaluate Rule 10b5-1 plans and share-ownership requirements**
- **Diversify holdings and harvest losses**
- **Evaluate factors to consider in deciding when, and how much, to sell.**

Regarding share ownership requirements expressed as a multiple of pay, executives may wish to check the employer's policies on recourse/enforcement in light of current stock market conditions. The reasoning behind restrictions on selling employer equity awards when executives are not in compliance with ownership requirements may be suspect if the stock has fallen 40%–50% in the year to date.

In the interest of [diversification](#) and tax-loss harvesting, executives may wish to explore liquidating employer stock positions where possible before year-end, especially in light of additional awards in future years.

When and how much to sell would depend on considerations unique to each executive, including:

- Employer share ownership requirements, guidelines, and culture.
- Trading restrictions imposed by SEC and by employer.
- Outlook for employer stock.
- Executive's investment time horizon and risk tolerance.
- Investment portfolio diversification objectives.
- Projected liability in personal federal and state income tax for the year, and the tax effectiveness of harvesting losses in employer stock.
- The potential merits of tax-loss harvesting in other stocks for future use against gains from future sales of employer stock.
- Type, timing, and expected value of future employer equity awards, e.g. stock options at Black-Scholes value

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vs. [restricted stock](#) at assumed total return vs. restricted units at assumed total return but with credit risk vs. long-term incentives with multi-year performance metrics.

- Executive's plans for charitable giving, which may include highly appreciated employer stock in light of implications for [estate tax and income tax](#).

Alan Ungar

*Critical Capital Management
Calabasas, California*

If you are holding company stock, this is not a good time to [sell](#) unless you must have the money. Right now losses are paper losses. By selling, you actually take a loss. The only other reason to sell occurs if you have substantial gains and want to offset the gains with losses (assuming there is a loss).

Exercising stock options now while the price of the stock is down is not a good idea. The only advantage of options is their [leverage](#). If prices are down, then leverage is up and so it would be a mistake to exercise now. The only advantage of exercising when the stock is down is that taxes would be less, but it is generally bad policy to let the tax tail wag the investment dog.

For restricted stock, NQSOs, and ESPP shares, I most always recommend that they be sold immediately. This because they are taxed, and I see no reason to exacerbate the risk. For the options: exercise and [sell](#) those with the least leverage.

Regarding [employee stock purchase plans](#) (ESPPs), and depending on the company and ESPP structure (such as the purchase discount), this is probably a good time to stop. The reason that at least part of the spread is [taxable](#) as income and the employee may end up having to hold the stock while it is going down. Generally (and I emphasize generally) it is better to [sell](#) those shares as soon as possible.

The guiding principle for all these decisions is your portfolio. When an employee receives some [restricted stock](#) it makes sense to [sell](#) it as soon as possible even if the market is down. The employee is being taxed on the total amount as if it were income, and so it makes sense to realize that income and not wait for the stock to go up.

Here is one example that reflects the times. A client exercised 16,000 incentive stock options (ISOs) in January, thinking that if the stock went down he could make a [disqualifying disposition](#) and eliminate the alternative minimum tax. His exercise price was \$6, and the market price at exercise was \$50. He had another 17,000 [nonqualified stock options](#) (NQSOs) at a strike price of \$10. He had to exercise the NQSOs by the end of the year. My normal recommendation is to exercise and [sell](#), for diversification purposes and because of my belief in passive investing.

However, the client wanted to hold the stock because he believed it would go up by at least 30%. Today the stock is at \$15. The strategy now is to exercise and hold the NQSOs and sell the ISOs. This makes sense because it would have taken him far too long to use up the [AMT credit](#), and the stock would have had to increase too significantly.

The possibility of increases in tax rates should not play a role in thinking about year-end planning. It's too hard to anticipate what is going to happen.

Carol Cantrell

*Briggs & Veselka
Houston, Texas*

My best tip is for those with ISOs to exercise them this year while stock values are low, even if it causes them to incur the [AMT](#). The reason is that when the Obama administration raises regular tax rates, those with AMT credits will recoup them fairly quickly. And by 2012 the credits will be four years old and [refundable](#). No more waiting until they expire!

By the time we get out to 2012, the remaining credit should be so small that 50% of it will nearly wipe it out. I am counting on [President Obama's tax rate increases](#) to use a lot of AMT credits between now and 2012.

Robert Pyle

*Diversified Asset Management
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We have been creating plans for [reverse dollar cost averaging](#). We try to set up

- **Don't sell depressed stock unless you need to**
- **Wait to exercise options**
- **Sell restricted stock at vesting and ESPP shares at purchase**
- **Future tax rates are hard to predict and should not affect planning**

- **Exercise and hold ISOs**
- **Don't worry about AMT, as AMT credit will be easier to use up in future**

- **Reverse dollar cost averaging can help with**

a schedule for the client to follow to reduce exposure to company stock. First we look for possible tax losses on ESPPs. Then we work on NQSOs and ISOs. I would like to see a 25% gain from the strike price of stock options before we think about exercising them.

We figure out how many years remain until the options expire and then multiply by four quarters. Then we set up a schedule to [sell](#) shares in approximately equal increments each quarter until the options expire. This method allows the client to dollar-cost-average out of their large position in their company stock and move into a more [diversified portfolio](#). Finally, if the client has a gain in ESPPs, they can sell some of these shares and offset capital losses in their taxable account.

For year-end planning, look to net gains and losses of company stock with a diversified outside portfolio. For example, if you have losses in your diversified portfolio, look to sell company stock with gains to net out losses and gains.

When someone sells, I look at ESPP shares first because you can net gains and losses out to minimize [taxes](#) (see above). The options have more chance of a large return because of the leverage factor. With restricted stock, I would sell in equal increments on a quarterly basis to get to zero exposure at retirement. Ideally, when the client retires, they have zero exposure to their company stock. Before retirement, I feel it should be no more than 5%–10%.

Jason Papier

*Fluent Wealth Partners
San Jose, California*

At the very basic level, for those with ISOs I recommend we exercise in [January 2009](#). I expect stock prices to still be depressed but also expect them to rise during 2009. That said, I'm wary of employees in smaller companies who have too much tied into that company: [401\(k\)](#), salary, and stock options. We will probably see a significant amount of companies going bankrupt or being taken private in 2009.

At a higher level, we're recommending that our clients who have significant stock holdings look at this as an opportunity for [estate planning](#). It's a great time to move shares out of a client's estate and into other structures, such as [GRATs](#). They can transfer more of their shares for the same amount of money than they could have a year ago. When these highly appreciable assets become more valuable, they can be sold without tax consequences. They can provide both the grantor with a steady stream of income and the grantor's heirs with a gift tax-free inheritance.

Finally, we're looking at the recently passed \$700 billion bailout package. Often we get new clients after they've made a mistake and realize they need professional help. In many cases this is because of AMT on ISOs and the related issues in a declining market. The bailout package includes a refund for those who were caught with AMT that was more than the value of their stocks, and who have large unused [AMT credits](#). We'll want to make sure we fully understand this ruling and how it can apply to our clients.

We're still keeping our eyes open with respect to [tax changes](#) because I'm uncertain how, what, and when changes will be made. The economic uncertainty will probably play a large role in the timing and degree of change. That said, it's a great time to harvest losses for [taxes](#). We [harvested](#) for all of our clients in November. Obviously, this will give us some cushion for future gains, in both the long and the short terms, and that will help to mitigate any tax consequences.

Likewise, with some clients we will try to harvest gains and match them with losses. So, for those who have bought and held, this can be a good opportunity to [sell](#) when values are lower, pair those gains with losses from other assets, and either diversify into substantially similar stocks or wait 30 days for the [wash sale rules](#) and repurchase the stock.

Example: You bought when the value was \$1, the value is currently \$5, and you expect it to reach \$10. If you assume capital gains will go up from 15% to 20%, and a 35% tax rate on ordinary income, you can sell at \$5. Ideally you pair the \$4 gain with a loss from another asset; but if not, you can still pay the 15%. Buy the stock back in 30 days and hold until \$10. When you sell at \$10, you are paying gains on only \$5 (\$10 sale price minus \$5 cost basis). If long-term capital gains go away and you are in a 35% tax bracket, then you're saving 20% on the first \$4 you made (or \$0.80 per share). Now, assume the client has \$1.5 million of company stock at today's \$5 value. The client would save \$240,000 in taxes with this strategy.

So we're very aware of the likelihood of a tax increase and we're looking to do what we can for our various clients, depending in large part on their own political and tax beliefs.

- **options**
- **Sell stock at a gain when you have losses to net against it**

- **Exercise and hold ISOs in early 2009**
- **Move company stock from your estate, e.g. with GRATs**
- **Harvest losses**
- **Potential tax changes add to choices for year-end planning**



Content provided by Lee McGowan of TFC Financial Management

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Neat! This collection of ideas from advisors confirms some of my own thinking and presents a few new ones to consider this year and for next. If only my company's stock price didn't drop so much. All this talk of tax loss harvesting will hopefully pay off when my company stock or other investments go up in value and this strategy reduces by taxes in the future.

Written by: Molly Albert on December 3, 2008

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