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19 Essential Rules, Concepts, and Strategies for Managing Concentrated Stock Positions and Stock Option Compensation

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MANAGING CONCENTRATED STOCK POSITIONS

Rule #1

Buying a Hedged Put Option

A *put option* affords an investor the right but not the obligation to sell a specified number of shares of the underlying stock, at a specified strike price, over a specified period of time, prior to expiration of the option. A *hedged put option* is created when an investor owns a stock outright and pays a premium amount to purchases put options on the stock he or she owns to protect the stock price in the case of a decline *(Knapp, 2001).*

Rule #2

Writing or Selling a Covered Call Option

A *call option* provides an investor the right but not the obligation to buy a specified number of shares of the underlying stock, at a specified strike price, over a specified period of time, prior to expiration of the option. A *covered call option* is created when an investor owns a stock outright and sells or writes *call options* on the underlying stock he or she owns, generating premium income, which is paid by the buyer of the *call option*. The *covered call* writer has the goal of modest appreciation and retention of the stock and income generation. This strategy only reduces the risk of a decline in the stock price by the amount of the premium paid, limits upside opportunity in excess of the strike price, and can result in loss of stock ownership and potential tax consequences if the stock is called away by the option purchaser upon reaching or exceeding the strike price *(Knapp, 2001).*

Rule #3

Zero Premium Collar

This is a strategy where an investor who owns a concentrated stock position simultaneously buys a *hedged put* and sells or writes a *covered call,* where the premium from the sale of the call option fully pays for the cost of the *put option*. This strategy provides the investor with downside protection below the *put strike price* and the potential for modest appreciation to the point of the *call strike price*. Investors who execute a *zero premium collar* still maintain both dividend income and voting rights. It is important for investors to note that a *zero premium collar* and other options based hedging strategies will stop the holding period clock used to determine long-term capital gains. Also, investors should be cognizant of the *constructive sale* rules which prohibit collars that are so narrow that they have in effect hedged away nearly all of the risk and reward *(Gordon, 2017).*

See important Listed Option Strategy Risk Disclosures at the end of this document.

Rule #4

Variable Prepaid Forward Contract

It is similar to a *collar* with a loan against it. This is a strategy where an investor with a concentrated stock position contracts with a brokerage firm to monetize the position and create liquidity upfront, while deferring taxes, and creating an upside ceiling or cap and a downside limit or floor. The upfront payment amount to the holder of the concentrated stock position is typically 75% to 85% of market value. The proceeds can be used for diversification or for another purpose such as purchasing real estate. At the end of the contract term the investor must deliver cash or a variable number of shares of stock, depending upon the market price at settlement, to satisfy the contract. Advantages of this strategy include liquidity, hedging the stock, tax deferral, and the right to dividends and voting. The disadvantages of this strategy are the loss of potential stock appreciation above the cap or ceiling and the built-in financing cost, and limitation on the amount of liquidity provided *(Knapp, 2001).*

Rule #5

Exchange Fund

This is a private placement typically structured as a limited partnership, where an *accredited investor* seeking diversification and tax deferral will transfer his or her stock of a publicly traded company to the fund *in-kind* for a required holding period of 7 years and in return receive a diversified interest in the fund and after the 7-year holding period be able to elect to receive shares *in-kind* of his or her original holding, a diversified basket of stocks, or cash. The fund is required to keep a minimum of 20% of its holdings in illiquid securities such as real estate so that stock exchanged is not considered a *constructive sale.* An *accredited investor* is one that has a net worth in excess of 1 million dollars (alone or with spouse), without including their primary residence, or earned income that exceeded $200,000 ($300,000 if married) in each of the two prior years and expects to do so for the current year as well. Advantages to this strategy include: no risk of depressing the market price, tax deferral (or tax savings if the stock is held until death for a *stepped-up cost basis.*), diversification, and the fund can accept contributions of restricted securities (avoiding the publicity of a public filing). Disadvantages include: illiquidity for a 7-year period, the fair market value of restricted securities are discounted, and all or part of the shares potentially will not be accepted by the fund manager *(Knapp, 2001).*

Rule #6

Net Unrealized Appreciation (NUA)

Executives who own a highly appreciated concentrated company stock position with a low cost basis in their 401(k), ESOP, or pension retirement plan may take advantage of this strategy, assuming that it is permitted by their employer retirement plan. According to IRC 402(e)(4), upon a *lump sum distribution* of company stock *in-kind* from an employer qualified retirement plan, the cost basis is taxed at ordinary income, while the *net unrealized appreciation* (the amount of unrealized gain above the cost basis) is given special tax treatment as a *long-term capital gain*. A *lump sum distribution* is one in which all assets are distributed within a single calendar year. While the premature distribution penalty of 10% for retirement plan distributions prior to 59½ still applies, only the cost basis incurs the 10% penalty. However, the *age 55 exception* to the 10% premature retirement distribution penalty, applies to employee distributions from company retirement plans such as 401(k)s, where the employee separates from service in the year he or she turns 55 or older. Once an employee rolls funds to an IRA the ability to use the *age 55 exception* is forfeited. Assuming the stock is held less than a year, ordinary income tax rates apply to any appreciation beyond the amount of *net unrealized appreciation* at the time of distribution. Assuming the stock is held over a year, any appreciation in price beyond the amount of *net unrealized appreciation* at distribution will be taxed as a long-term capital gain and this additional appreciation will get a *stepped-up cost basis* if held at death. In contrast, the *net unrealized appreciation* will count as income in respect of decedent or "IRD" at death and will be taxed as a long-term capital gain to their heirs, and no *stepped-up cost basis* is received by their heirs for the *net unrealized appreciation*. An investor can take advantage of an IRA rollover of part of his retirement plan assets and perform a *lump sum in-kind distribution* of his employer stock for part of his distribution to obtain *NUA* treatment on the employer stock. It is important to note that once company stock is rolled over to an IRA the opportunity to take advantage of *net unrealized appreciation* is lost. Sometimes executives will cherry-pick share lots with the lowest cost basis to earmark for *net unrealized appreciation* treatment. Of course, this strategy is contingent upon obtaining the proper records *(Investopedia, 2017).*

Rule #7

Charitable Remainder Trust

This is a strategy where an investor takes a highly appreciated asset such as real estate or a concentrated stock position, and deposits it into an irrevocable trust, in exchange for an income stream for life, an immediate charitable deduction, and no tax upon the sale of the asset within the trust. In addition, the donor has effectively removed the asset from his estate and has asset protection from creditors because the asset was contributed to an irrevocable trust. The remainder amount goes to the selected charity upon the death of the donor. A charitable remainder unitrust or CRUT is created when a fixed percentage payment is made each year variable upon the annual value of the investments inside the trust. A charitable remainder annuity trust or CRAT is created when a fixed *amount* is paid each year to the donor. IRS rules mandate a minimum payout of 5% and a maximum of 50% of the initial amount of the charitable remainder trust. Payments can continue to one's spouse after his or her death. Often, a grantor will purchase life insurance to make up for the assets that are contributed to the charitable remainder trust so that his or her children receive the same amount of inheritance. Charitable remainder trusts may be *inter vivos* or made during one's lifetime or *testamentary* or made at death *(Knapp, 2001).*

MANAGING STOCK OPTIONS

Rule #8

Incentive Stock Options (ISOs)

Stock options granted to a limited class of employees, such as top level executives. ISOs are not tax deductible by the company when they are exercised. In addition, ISOs are non-transferrable, except at the death of the holder. The amount of ISOs that can be exercised in any one calendar year is $100,000.00 worth, based on the valuation at the time the options were granted. Vesting schedules can be cliff vesting where the options all vest on a specific date typically several years in the future or gradual vesting where the options vest at a percentage amount per year such as 20% a year for 5 years. ISOs receive special tax treatment if they are sold in compliance with the two-year holding period from the original grant date and the stock is held for one year after exercise prior to disposition. Rather than ordinary income tax being due at the time of exercise on the bargain element, or the difference from the exercise price and the fair market value of the stock at the time of exercise, only preferential long-term capital gains rates are applicable when the stock is sold. It is important for investors to note that the bargain element counts as a preference item for the calculation of AMT or *alternative minimum tax* liability. Often investors will consider the AMT liability, the preferential tax treatment of the ISOs, and their outlook for the company stock, and determine whether it makes sense to make a *disqualifying disposition,* by selling the ISOs early and in effect having them treated as *Non-qualified stock options* or NSOs and pay ordinary income tax on the bargain element *(Knapp, 2001).*

Rule #9

Non-Qualified Stock Options (NSOs)

Stock options that are widely distributed to employees, directors, and consultants and are transferrable. Similar to ISOs, NQOs will have a vesting schedule. The options are not subject to tax upon the grant date. Unlike ISOs, non-qualified stock options or NSOs are taxed at ordinary income tax rates on the *bargain element,* or the difference between the exercise price and the fair market value of the stock when the employee exercises their options, regardless of whether the shares are sold for cash or held for further capital appreciation. If the shares are sold over a year after the exercise date, the tax treatment will be a favorable long-term capital gain, on the appreciation from the fair market value at exercise to the appreciated sale price. If the shares are sold within a year or less from the exercise date, the appreciation from the fair market value at exercise to the higher sale price will be taxed at ordinary income tax rates *(Knapp, 2001).*

Rule #10

83(b) Election

It is an election that allows tax payers to choose to pay taxes when compensation in the form of restricted stock or options is granted at ordinary income tax rates, in exchange for the benefit of paying long-term capital gains tax when the restricted stock or options vest and are sold. It is important to note that employees cannot make an *83(b) election* for restricted stock units or (RSUs). The election must be made within a 30-day period from the grant date. By selecting to make the *83(b) election,* investors do not incur taxes upon vesting as they would without making the election, but rather only incur taxes upon the sale of the securities. As long as the shares are held over a year after the grant date, the investor who makes the *83(b) election,* pays the favorable *long-term capital gains* tax rate, currently at a maximum of 20% vs. the maximum ordinary income tax rate of 37%. Investors who fail to make the *83(b) election* must pay ordinary income tax at the time of vesting. An additional benefit of filing an *83(b) election* is that it establishes a *long-term capital gain* holding period earlier, right after the grant date, without having to wait until a year after the vesting date. Procedurally the original form should be filed with the IRS, a second copy should be sent to the company, and a third should be kept by the taxpayer for his or her records. While the *83(b) election* provides investors with a valuable benefit of potentially reducing taxes on the *bargain element,* or the excess of the stock's fair market value at the time of exercise and the exercise price, for options, and the potential for reducing taxes on the appreciation from the grant date to the fair market value on the date of vesting for restricted stock, if the price declines investors have paid taxes on a security that they actually lost money on. In the case of a loss, investors who made an *83(b) election* can claim the tax overpayment amount as a capital loss, only upon the sale of the stock. Also no deduction is allowed if there is forfeiture because the stock or options do not vest *(Knapp, 2001)*.

Rule #11

Cashless Exercise

This is the most common way that option holders will "exercise and sell" because they need the cash or desire to lower their exposure to their company stock. A brokerage firm lends the option holder the funds to purchase the shares at the exercise price and at the same time the shares are liquidated at the market, entitling the option holder to the proceeds representing the *bargain element,* or the difference between the fair market value at exercise and the exercise price, minus transaction costs *(Knapp, 2001)*.

Rule #12

Exercise and Hold

If an investor believes there are good long-term prospects for the company stock, he or she is not looking to diversify his or her holdings, and they have the funds to earmark for the option exercise, they will "exercise and hold," and typically keep the options for over 12 months for a *long-term capital gain (Knapp, 2001)*.

Rule #13

Exercise and Sell to Cover (Partial Sale)

For this strategy the investor will exercise stock options to purchase employer stock and at the same time sell shares to cover the options cost, taxes, and brokerage fees, while the remaining stock is typically held for a *long-term capital gain (Knapp, 2001)*.

Rule #14

Stock Swap or Pyramiding

The investor's objective for this strategy is to exercise and hold. This strategy must be permitted by the stock option plan document and can be allowed for NSOs or ISOs. The investor funds the cost of exercise with shares that he or she already owns. Similar to a cash exercise, the *bargain element,* or the difference between the fair market value at exercise and the exercise price, is taxable at exercise for NSOs and a preference item for AMT for ISOs. By implementing this strategy, investors benefit from not having to realize a capital gain from the sale of the stock used to swap. Some plans will offer a *reload* benefit where investors can replenish stock that was contributed to exercise options *(Knapp, 2001)*.

Rule #15

Gifting of Options

This strategy allows the option holder to remove options from his or her estate. This strategy is only allowed for NSOs, except ISOs may be transferred to an employee's beneficiaries upon death. The company must allow gifting of options and the gift must be in the scope allowed, such as to a family member or trust for family. The employee donor will be subject to federal tax upon gains associated with the exercise of the gifted options *(Knapp, 2001)*.

RESTRICTED STOCK

Rule #16

Restricted Stock

This is another form of executive compensation and an alternative to stock option grants, where stock vests because of the lapse of time or completion of performance goals. They are taxed at ordinary income upon vesting and counted as an expense to the issuer at vesting. However, an 83(b) election can be made to secure long-term capital gains treatment. Unlike options, restricted stock can retain dividend and voting rights. In contrast to options, some value is established even if the price declines *(Petra, 2012)*.

Rule #17

Rule 144

This rule allows executives to publicly liquidate restricted or control securities if specific rules are followed. The requisite holding period for restricted stock in a public company is 6 months, while for a private company, the requisite holding period is one year. In addition, there must be sufficient information obtainable by the public about the company, such as who are the officers and directors, a description of the business, and financial records. Furthermore, no more than 1% of the shares of the company can be sold over a 3-month time frame. If the stock is listed on a stock exchange, the greater of 1% of the company shares, or the average of the most recent 4-week trading volume can be liquidated. Another requirement is that brokers cannot solicit purchase orders and are not allowed to charge higher than normal commission rates. Lastly, a notice must be filed if the value of the stock to be liquidated is in excess of $50,000 over a three-month time frame or there is over 5000 shares that are to be sold. One exception is that if the seller is not associated with the employer that issued stock and the seller has held the shares in excess of one year, he or she is exempt from the above requirements. Also non-affiliated people can liquidate their stock if they held the shares for over 6 months, if the public information requirement is satisfied *(SEC, 2017)*.

Rule #18

Short Swing Profit Rule

This rule prohibits insiders from buying and selling company stock for a profit within a 6-month period. An *insider* is defined as a person who owns over 10% of the company stock or is a director or officer. The purpose of the rule is to prevent insiders from unfairly trading on inside information. The rule requires any profits in violation of the short swing profit rule must be disgorged and given back to the company *(SEC, 2017)*.

Rule #19

10b5-1 Trading Plans

These are trading plans that are set up in advance so that *insiders* such as c-suite executives, board of directors, and employees subject to window periods can sell restricted stock without having to worry about blackout periods, because the plan has already pre-determined the amount, price and date the stock will be liquidated at *(Gordon, 2017)*.

Citations

Important Listed Option Strategy Risk Disclosures

Options involve risk and are not suitable for all investors. Before opening an option position, a person must receive a copy of "Characteristics and Risks of Standardized Options." This document is available from Sarver Vrooman Wealth Management Group of Wells Fargo Advisors at 1900 Shawnee Mission Parkway, Suite 210, Mission Woods, KS 66205, 913-267-7169, or the Options Clearing Corporation, One North Wacker Drive, Suite 500, Chicago, Illinois 60606. Please read it carefully before investing

Option Strategy Hedging Considerations

Underlying assets and its related hedges are expected to move in opposite directions, but not necessarily on a one-for-one basis. The tax status of dividends may change when hedging.

Purchase of a protective put

Given no change in the price of an underlying stock, the value of a put option premium will fall over time and eventually expire worthless. When combined with no change or a rise in the price of an underlying stock, the erosion of a put option premium may reduce overall portfolio returns. This strategy raises the break-even on the underlying by the amount paid for the put.

Using collar strategies

Portfolio values are limited at both upper and lower boundaries, as determined by the respective strike prices of the put and call options. There may be an "opportunity cost" associated with a collar since an investor restricts the potential upside benefit, should the underlying stock increase in value beyond the strike price on the short call options Underlying shares will likely be assigned if stock price is above the written call strike price. Investors should consider legal and tax issues, and consult an attorney and tax professional with any questions regarding option hedging strategies.

Options Strategies Covered Call Considerations:

Call sellers may forego participating in upward share price movements. Covered call positions will only benefit from stock price gains up to the sum of the option strike price, plus the premium amount collected. Reduced upside returns can result if the underlying stock moves "in the money" (increases beyond the short call strike) on or before expiration. Foregone opportunity cost may represent substantial value in the face of a rapid or persistent upward move in the underlying stock Covered shares may be assigned. May require delivery of low cost basis shares or cash settlement of options position. Loss of dividend can result due to early assignment of "in the money" positions. Investors retain downside risk of stock in excess of the premium collected. Small decreases in underlying share value can be offset by premium income received. Premium income received may not fully recover the loss of value from a stock price decline

Gordon, R., & Lyman, C. (2017). Restricted Stock and Restricted Stock Units. Retrieved December 11, 2017, from http://www.mystockoptions.com/

Knapp, T. L. (2001). *Understanding Employee Stock Options, Rule 144 & Concentrated Stock Position Strategies*. Lincoln, NE: Writers Club Press.

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SEC. (2013, January 16). Rule 144: Selling Restricted and Control Securities. Retrieved December 11, 2017, from https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html