

## StockOptions

### How Tax Rate Changes Impact Strategies For Stock Options & Restricted Stock (Part 1)

Stanley Trotta with Robert Gordon

You believe a tax hike is on the horizon, whether in 2009 or when the current rates expire after 2010. This leads you to consider re-evaluating your current financial-planning strategy for your equity compensation and current company stock holdings to determine whether immediate action is required this year or before new rates apply.

This article series looks at whether the likelihood of tax rate changes should drive your decisions to exercise stock options or to sell stock that you received from an option exercise or restricted stock vesting. Part 1 looks at nonqualified stock options (NQSOS) and restricted stock. Part 2 will analyze incentive stock options (ISOs).

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**Should you take action with your stock options and restricted stock now or wait for new tax rates?**

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#### NQSOS

Your equity compensation package may include nonqualified stock options (NQSOS), as they are the most common form of stock option grant. As with all employee stock options, they allow you to purchase company stock at a preset price (i.e., the exercise or strike price). This right to purchase the stock is usually limited to a term no greater than 10 years (check your grant agreement for specifics on the term and vesting). As a component of compensation, NQSOS are subject to ordinary income tax rates when the options are exercised. It is at this point that the difference between the fair market value (FMV) of the company stock and the exercise price (i.e., the bargain element or spread) is treated as wages and subject to taxation. (For more tax and reporting details, see [NQSOS: Taxes and the relevant sections of the Tax Center.](#))

Let us explore some considerations for your NQSOS when tax rates go up.

**Example:** You have 1,000 NQSOS with an exercise price of \$10. The current fair market value (i.e., current trading price) is \$15. Your federal tax rate for additional income (i.e., your marginal tax rate) is 35%. The NQSOS will expire in three years (within the next presidential term, so waiting for a subsequent presidential administration is not an option). To simplify the example to isolate the impact of a federal tax rate increase, your state does not have an income tax and you have maxed out on your Social Security tax (i.e., only Medicare tax applies).

*Question: Does it make sense to exercise the options, sell the stock, and invest the proceeds from an NQSO before there is a rise in the ordinary tax rate?*

You first determine the current net value of the NQSOS. To keep matters simple, we will assume a "cashless exercise" whereby your taxes and exercise costs are immediately paid for from the stock option value, calculated as follows:

|                         |                |                   |
|-------------------------|----------------|-------------------|
| Gross value             | \$15,000       | (\$15 x 1,000)    |
| Less exercise price     | (\$10,000)     | (\$10 x 1,000)    |
| Less federal income tax | (\$1,750)      | (\$5,000 x 0.35)  |
| Less FICA taxes         | (\$73)         | (\$5,000 x .0145) |
| <b>Net value</b>        | <b>\$3,177</b> |                   |

When the federal income tax rate rises to 40%, the NQSOS net value drops to \$2,927 (assuming no stock price increase), a decrease of approximately 8%. *This simple observation alone may cause you to act rashly and immediately liquidate the NQSOS.* But that 8% decrease in value should be balanced against the impact of paying taxes three years earlier than necessary.

While it is clear that an increase in ordinary tax rates would have a negative impact on the net value of NQSOS, you must consider the alternative. To determine whether immediate action is required, you should compare a *Hold The Options Unexercised* strategy with an *Exercise, Sell & Invest* strategy.

If you continue to hold your unexercised options, you are still "invested" in your company's stock, which may increase or decrease between now and expiration of the NQSOS. Therefore, you need to factor in the expiration date of the NQSOS to set the time horizon.

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**Estimate the after-tax growth rate of an alternative investment to calculate the break-even point between the**

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If you choose to exercise before the end of the term, perhaps to diversify your net worth away from company stock, you are able to invest the NQSO profits in any manner you find attractive. Therefore, you need to estimate the after-tax growth rate for the replacement investment to calculate a break-even point between the two strategies. You should still do this analysis when your alternative investment is just keeping the sale proceeds in a money market account or putting them in T-bills. It can prevent you from exercising merely because tax rates are likely to go up.

**strategies of either holding unexercised options or exercising, selling, and reinvesting. This analysis can prevent you from exercising merely because tax rates are likely to go up.**

For the above example, the time horizon is set at three years, since NQSOs are typically exercised just prior to expiration. For a *Exercise, Sell & Invest* strategy, the \$3,177 of initial proceeds would grow to \$3,679 by the end of year three, assuming the replacement investment has an after-tax growth rate of 5% ( $\$3,177 \times 1.05^3$ ).

The break-even point for a *Hold The Options Unexercised* strategy will be achieved when your company's stock grows at a 2.77% annual rate, or the share price reaches \$16.28 by the end of year three. At this point, the shares will have grown by \$1.28 and the NQSOs will be worth \$3,677, calculated as follows:

|                           |                |                   |
|---------------------------|----------------|-------------------|
| Gross value after 3 years | \$16,280       | (\$16.28 x 1,000) |
| Less exercise price       | (\$10,000)     | (\$10 x 1,000)    |
| Less federal income tax   | (\$2,512)      | (\$6,280 x .40)   |
| Less FICA taxes           | (\$91)         | (\$6,280 x .0145) |
| <b>Net value</b>          | <b>\$3,677</b> |                   |

The following table illustrates the impact an increase in the spread will have on the break-even analysis. You will see that the greater the current spread, the higher the annual growth rate of your company stock must be for the *Hold The Options Unexercised* strategy to break even with the *Exercise, Sell & Invest* strategy.

|   |        |        |        |        |
|---|--------|--------|--------|--------|
| FMV/stock price at exercise                                   | \$15   | \$20   | \$25   | \$30   |
| Exercise price  | \$10   | \$10   | \$10   | \$10   |
| Spread (FMV less exercise price)                              | \$5    | \$10   | \$15   | \$20   |
| Stock's annual growth rate                                    | 2.77%  | 4.10%  | 4.89%  | 5.40%  |
| Average annual required stock price increase over three years | \$0.42 | \$0.82 | \$1.22 | \$1.62 |

Clearly, the current value of your company's stock will have a significant impact on your decision. In the above case, if the stock was currently valued at \$15, you might choose *Hold The Options Unexercised*, as a 2.77% annual growth rate for the next three years might seem reasonable. However, if your company stock was currently valued at \$30, the bigger spread might cause you to choose *Exercise, Sell & Invest*, if you felt that a 5.4% growth rate for the next three years was not attainable.

The break-even analysis provides the hurdle rate the company stock must beat for a *Hold The Options Unexercised* strategy to be maintained (assuming a cashless exercise). If you expect the company stock will not beat the hurdle rate, the NQSOs should be exercised, the shares sold, and the proceeds redeployed to an alternative investment.

**The break-even analysis provides the hurdle rate the company stock must beat for a *Hold The Options Unexercised* strategy to be maintained.**

*Summary Of Variables*

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Your decision on what to do is based on three main variables: (1) current stock price; (2) exercise price, which, together with the stock price, determines how much your stock options are now in the money (i.e., how much spread); (3) expiration date. It becomes critical for you to evaluate each NQSO grant separately, as they will have different exercise prices and expiration dates. When doing so, you may find that some grants should be exercised now and some grants held. The analysis of whether to continue holding NQSO stock that has appreciated after exercise is similar to the analysis discussed below on whether to sell restricted stock that has appreciated after it vests.

### Restricted Stock

Your equity compensation package may also include restricted stock or restricted stock units (RSUs). Their features are very similar so we will use term "restricted stock" in this article to refer to both. These grants of company stock vest at a future date and have value no matter how much the stock price has dropped since grant.

Due to this future vesting feature and risk of forfeiture, these grants are generally treated as compensation on the vesting date and not on the grant date. At that point, the full fair market value of the shares is taxed at ordinary income rates. (For more tax and reporting details, see Restricted Stock: Taxation.) However, for restricted stock (but not RSUs), you can make a tax election, called a Section 83(b) election, within a 30-day window from grant date. In this way, the restricted stock is taxed immediately according to the stock price on the grant date, and any subsequent gains are then taxed at capital gains rates. Your company will need to withhold tax from you in some way, as you cannot sell the stock itself until it later vests.

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**With a looming tax hike, determine whether immediate action is required. Consider the two times when you have decision-making power with restricted stock.**

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For our discussion, we will assume that vesting and release are on the same date. Some RSU plans have a deferral feature, which, like waiting to exercise NQSOs, can complicate the analysis.

With a tax hike looming, you must determine whether immediate action is required before the tax rate rises. There are two times when you have decision-making power. One is after the restricted stock or RSUs vest, and the other (for restricted stock only) is during a 30-day window from the date of grant.

Let us consider these two scenarios.

#### First Scenario: Keep Holding Appreciated Company Stock

**Example:** You received a restricted stock grant of 10,000 shares at a price of \$5. The restricted stock grant vested and the shares were released at a price of \$10. The shares have appreciated since vesting and are currently valued at \$20.

*Question: Does it make sense to sell the shares now and pay capital gains taxes at the current 15% rate or to hold the shares to a future date, despite a rise in the capital gains rate?*

The following chart demonstrates the negative impact of an increase in the capital gains tax rate:

| Tax rate                        | 15%              | 20%              |
|---------------------------------|------------------|------------------|
| FMV of restricted stock         | \$200,000        | \$200,000        |
| Tax basis (FMV at vesting date) | \$100,000        | \$100,000        |
| Taxable amount                  | \$100,000        | \$100,000        |
| Less capital gains tax          | (\$15,000)       | (\$20,000)       |
| <b>Net proceeds</b>             | <b>\$185,000</b> | <b>\$180,000</b> |

As you saw with the analysis involving NQSOs, the change in capital gains rate alone should not drive a decision to sell the stock now. Although a 33% increase in the capital gains rate from 15% to 20% seems big, its impact on the after-tax gains from your restricted stock is much smaller (in this example of \$185,000 to \$180,000 it's only 2.7%). But a determination that the tax hit was not as large as you might have expected should not cause you to be complacent. You need to determine what it will take in future stock price appreciation (if anything) to recoup the hit by the tax increase. This then lends itself nicely to a *Hold The Stock* strategy vs. a *Sell & Invest* strategy.

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First, you determine the starting point values. For a *Hold The Stock* strategy, the starting point value is \$200,000, as you would simply continue to hold the shares from the restricted stock vesting (you would also use this analysis for stock acquired through an NQSO exercise). Remember that your basis is the vesting date value (for NQSOs, it is the stock price at exercise). For a *Sell & Invest* strategy, your starting point is \$185,000 (with full basis), as demonstrated above. Next, you need to estimate growth rates. To get a sense of how each strategy will play out, let us first assume that the growth rate for each strategy is identical.

**The hike in the capital gains rate alone should not drive a decision to sell now. Determine what it will take in stock price appreciation (if anything) to recoup the hit by the tax increase.**

With a 6% growth rate, you find that a *Sell & Invest* strategy outperforms a *Hold The Stock* strategy through year five, when the capital gains rate is 20%. Then, by year six, a *Hold The Stock* strategy reaches a break-even point and outperforms a *Sell & Invest* strategy, illustrated as follows:

|  | Hold             | Sell & Invest    |
|--|------------------|------------------|
| Starting point                           | \$200,000        | \$185,000        |
| Tax basis                                | \$100,000        | \$185,000        |
| Value at year six (at 6% growth)         | \$283,704        | \$262,426        |
| Less built-in capital gains taxes at 20% | (\$36,741)       | (\$15,485)       |
| <b>Net value</b>                         | <b>\$246,963</b> | <b>\$246,941</b> |

When the growth rate for both strategies is identical, you find that a *Sell & Invest* strategy comes out of the gates strong, but at some future point a *Hold The Stock* strategy catches up and then outperforms a *Sell & Invest* strategy. The rate at which the *Hold The Stock* strategy will catch up is determined by the assumed growth rate for both strategies.

Based upon the above fact pattern, here are the break-even points for a *Hold The Stock* strategy (assuming the capital gains rate is increased to 20%):

| Growth rate for both strategies:                             | 1% | 2% | 3% | 4% | 6% | 10% |
|--|----|----|----|----|----|-----|
| Year in which break-even point for hold strategy is reached: | 36 | 18 | 12 | 9  | 6  | 4   |

The lower the assumed growth rates, the longer it takes the *Hold The Stock* strategy to catch up. This break-even point will help you decide what to do with your company stock. If you plan on using these funds at some point within this period, you would presumably sell your company stock now, pay the taxes, and invest the proceeds.

However, the growth rate for each strategy is not likely to be the same. Therefore, let us consider what happens when growth rates between the two strategies differ. What is interesting here is that a small difference between the growth rates of either strategy will have a major impact.

*What if the growth rate of the new investment is greater than your company's stock growth rate?*

You may be surprised to find that if the new investment grows at merely 1% greater than your company's stock, a *Sell & Invest* strategy will always outperform a *Hold The Stock* strategy. Under these circumstances, you would presumably sell your company stock, pay the taxes, and invest the proceeds. This would be the case even if the tax rates were not to increase.

*What if the growth rate of your company's stock is greater the growth rate of*

**When the growth rate for both strategies is identical, *Sell & Invest* starts strong, but at some future point *Hold The Stock* catches up and outperforms it. However, when your company stock performs at 1% or greater than a new**

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the new investment?

On the other hand, when your company stock performs at 1% or greater than a new investment does, you find that the break-even point for a *Hold The Stock* strategy is reached within two to three years. Given the likely depressed price of your company's stock and your predictions on how quickly it may recover, this may lead you to hold it even with the tax increase on capital gains ahead.

**investment, the break-even point for *Hold The Stock* is reached within two to three years.**

Now here are the break-even points for a *Hold The Stock* strategy based upon the above fact pattern when your company stock performs at only 1% greater than the new investment:

|   |    |    |    |    |    |     |
|---|----|----|----|----|----|-----|
| Growth rate for <i>Hold The Stock</i>                               | 2% | 3% | 4% | 5% | 7% | 11% |
| Growth rate for <i>Sell &amp; Invest</i>                            | 1% | 2% | 3% | 4% | 6% | 10% |
| Year in which break-even point for <i>Hold The Stock</i> is reached | 3  | 3  | 3  | 3  | 3  | 2   |

### Second Scenario: Pay Taxes At Grant

**Example:** You received (within the past 30 days) a grant of 10,000 shares of restricted stock when the current market price was \$5 per share (or you are expecting a restricted stock grant in the near future). The restricted stock grant will vest in two years.

*Question: Does it make sense to elect to have the restricted stock taxed now and pay ordinary taxes at the current 35% rate? Or is it better to wait until vesting to pay the taxes, despite a rise in the ordinary tax rate?*

One benefit of making a Section 83(b) election is that any additional appreciation from grant date to ultimate disposition will be taxed at the capital gains rate. Major drawbacks of making the 83(b) election include the possibility that you may forfeit the restricted stock before it vests, or that the value of the shares may drop significantly by the vesting date.

In the wake of a tax increase, a driving factor for making the 83(b) election is the potential tax savings. Remember, to entertain the notion of an 83(b) election, you must have a "tax fund" (i.e., extra cash) to pay the tax immediately at grant instead of waiting to be taxed at vesting. Now, the forgone potential appreciation of the tax fund you used to pay the tax liability resulting from the election will offset the ultimate benefit from the 83(b) election. If you determine the growth rate of return necessary to beat the tax benefit, you can determine whether the *83(b) Election* strategy would make sense. In other words, will you make more money by keeping the tax fund invested than you would from the tax savings of an 83(b) election?

**Will you make more money by keeping the tax fund invested than you would from the tax savings of an 83(b) election?**

For the above example of the restricted stock grant vesting in two years, you will find the *83(b) Election* strategy is advantageous under the following conditions (assuming an increase in ordinary income tax rate to 40% and the capital gains rate to 20%):

1. When the after-tax annual growth rate for the tax fund used to pay the tax is lower than 6.9% (the break-even rate) from the grant date through the vesting date.
2. When the value of the restricted stock remains constant (no growth).

This analysis, which focuses on the alternative returns for the money used to pay taxes early, can be expressed as follows:

### 83(b) Election

|  |          |
|--|----------|
| Start with your tax fund<br>[RS grant date value x 35% (current rate)] | \$17,500 |
|  |          |

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|   |                 |
|---|-----------------|
| <b>Less</b> the income taxes<br>[RS grant date value <b>35%</b> (current rate)]   | (\$17,500)      |
| <b>Add</b> your RS grant date value   | \$50,000        |
| <b>Add</b> projected appreciation of RS from<br>grant date to vesting date (we assumed<br><b>0%</b> )                                   | \$0             |
| <b>Less</b> capital gains tax at <b>20%</b> (future<br>capital gains rate) on the appreciation in<br>RS from grant date to vesting date | \$0             |
| <b>Net future value</b>   | <b>\$50,000</b> |

versus:

### Hold

|   |                 |
|---|-----------------|
| Start with your RS grant date value   | \$50,000        |
| <b>Add</b> projected appreciation of RS from<br>grant date to vesting date (we assumed<br><b>0%</b> ) | \$0             |
| <b>Less</b> ordinary tax at <b>40%</b> (future rate)  | (\$20,000)      |
| <b>Add</b> tax fund<br>[RS grant date value x <b>35%</b> (current<br>rate)]                           | \$17,500        |
| <b>Add</b> projected after-tax appreciation on<br>tax fund through vesting date at <b>6.90%</b>       | \$2,500         |
| <b>Net future value</b>   | <b>\$50,000</b> |

In the above example, you would make the 83(b) election if you could not get an annual after-tax growth rate of 6.9% on your tax fund. You will find that if the vesting were extended beyond two years, the required growth rate on the tax fund would become lower. In these cases, it would be less likely that you would make the 83(b) election.

However, we did not factor a growth rate for your company stock. As we noted above, if you make an 83(b) election, subsequent gains on your company stock are taxed at capital gains rates. This is an additional benefit of the 83(b) election. Therefore, when you factor in growth for your company stock, you will find the 83(b) election more attractive, as it would take a much higher growth rate on the tax fund to break even.

For the above example, if you assume that your company stock grows at a 5% annual rate over the next two years, you would make the 83(b) election if you could not get an annual after-tax growth rate of 9.61% on your tax fund, thereby making an 83(b) election more appealing.

This comparative analysis may provide some guidance for your decision-making process. However, you must thoroughly explore the risks of forfeiture or precipitous price declines before making an 83(b) election.

### No Simple Answers

We looked at the impact of an increase in tax rates. However, given that changes in the world of finance occur almost daily, many other variables may cause you to revise a current strategy. These include the risk associated with holding a single stock, the need to diversify, sudden changes in the quality of the underlying company, your position and future with the company, and possible blackout periods that restrict your ability to exercise at will.

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**Clearly, planning with stock options and restricted stock is not for the faint of heart. The back-of-the-envelope calculations will not cut it.**

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Clearly, planning with stock options and restricted stock is not for the faint of heart. The back-of-the-envelope calculations will not cut it. You must work with your tax and financial advisors to develop an action plan that is tailored to your specific situation. Regardless of whether you have NQSOs, restricted stock, ESPP stock, or ISOs (to be discussed in Part 2), careful planning and number-crunching are the only ways in which decisions should be made. Constant vigilance is warranted, for immediate action may be required at any time. A thorough understanding of the variables will allow you to explore and develop an appropriate course of action.

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*This article was published solely for its content and quality. Neither the authors nor their firms compensated us in exchange for its publication.*

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