



# How to Manage Employee Stock Options

BY KENNETH B. SHAPIRO, CPA, SHAPIRO FINANCIAL SECURITY GROUP INC.

Clients often want to know how they can save on taxes on their employee stock options. You mention doomsday scenarios at Enron and the dot-com busts, but they say, “That won’t happen to my company.” So we listen, give clients our opinion and send them on their way, hoping their company isn’t the next Bear Stearns.

Few examples can demonstrate financial and market risk like employee stock options (ESOs). These contractual agreements — given as retention, motivation and reward incentives within a compensation package — can be an excellent wealth-accumulation vehicle. They provide tax-deferred growth in shares of company stock above a designated “strike” or purchase price. Depending on the option, there could also be tax advantages realized upon sale. Unfortunately, a company’s stock price doesn’t always go up.

## Unfinished Business

After the 2001 market crash, many corporations eliminated ESOs in favor of restricted stock grants. But the number of grants outstanding had already grown tenfold from 1992 thru 2001, with most of that growth occurring after 1998. Nearly two-thirds of the awards were granted to non-senior management personnel. Since a typical grant does not expire for 10 years, and with employees holding the grants as long as possible, many of those grants given during 1998-2001 still need to be acted upon.

## Volatility

It’s important to remember that employee stock options are highly leveraged financial vehicles. A 20-percent change in a company’s stock price can result in a significantly

higher percentage gain or loss in an option portfolio. Their valuations are impacted by price fluctuations above the strike price (in-the-money value), the time remaining until the option’s expiration (time value) and the stock’s volatility.

In-the-money grant values held by hard-working Bear Stearns employees were wiped out in weeks. As a result, many retirement and college funds no longer exist. Even the most egregious of tax consequences would not have cost them 100 percent. It’s an extreme, but effective, example of why saving taxes should be the last objective addressed, not the primary one.

## Who to Turn To

Studies have shown that companies have done a bad job of training their employees to understand the risks and rewards inherent with these grants and their ability to manage them on a non-emotional basis. If we as CPAs are to be trusted advisors, we have a fiduciary responsibility to make sure clients are aware of these risks and can prudently survive adverse outcomes that may result from transactions and decisions material to their benefit.

## Deciding Factors

Several things should drive the decisions to exercise and/or sell shares under vested option grants (1) What is the intended use of the proceeds? (2) When are the proceeds needed? (3) How far “in the money” is the position? (4) What is the client’s risk-tolerance level? (5) How much does the value of company stock represent as a percentage of the client’s overall portfolio?

The earlier the need for the funds, the more the stock’s price volatility

and the lower the client’s risk-tolerance level, then the sooner the client should take action. Monitoring a targeted ratio that measures the remaining time value as a percentage of a grant’s total value helps eliminate the emotional noise that creates confusion as to when the client should act.

The lower the percentage of remaining time value, the more the client’s funds are at risk. These ratios may sound an alarm even though clients can have 2-3 years remaining until the option grant’s expiration date.

## Know When to Hold, When to Fold

Once the need for action is identified, tax analysis can help make the transaction as tax efficient as possible. However, risk/reward considerations still need to be considered. Although an opportunity may exist to convert ordinary income into capital gains treatment (on incentive stock options), subjecting potential proceeds to another year of market fluctuation may not be worth the tax savings. Sometimes, cashing in shares at ordinary tax rates upon reaching each vesting milestone may be wisest. Just ask former employees of Bear Stearns. ❏

---

*Kenneth B. Shapiro, CPA, PFS, CFP, is the principal at the Shapiro Financial Security Group Inc. He is a member of the New Jersey Society of CPAs Tax Resource Group and the Financial Services Resource Group. Shapiro can be reached at [kshapiro@shapirofsg.com](mailto:kshapiro@shapirofsg.com) or 732-739-8991.*