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7 Biggest Mistakes

Tech Executives Make on their Stock Compensation Plans

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For many of our clients (i.e. successful Technology Executives), typically, at least 50% of their overall compensation comes from their company's stock plans, in various forms (e.g. RSUs, ISOs, NQSOs, SARs, Deferred Compensation, ESPP, etc.). Although it can be exciting to know that their compensation can be significantly enhanced by their company stock, oftentimes, they make common mistakes that ultimately cost them hundreds-of-thousands, if not millions, in total compensation.

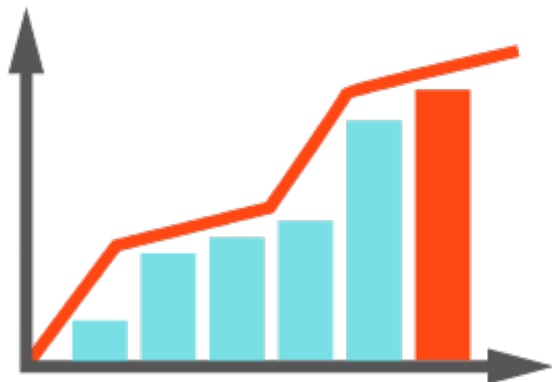
Read the seven most common mistakes our firm sees when working with Executives.

Mistake 1: Exercising Too Early

Incentive Stock Options (ISOs), though more common 20 years ago, are still being granted to executives, especially at early-stage companies. ISOs have some distinct tax advantages (long-term capital gains tax treatment with proper hold requirements), but they are tricky (e.g. exposure to AMT). The most under-appreciated (and under-utilized by the executive) characteristic that ISOs carry is its "time leverage" and its "price leverage." Most ISOs can be held for 10 years from its initial grant date. This span of 10 years provides a lot of leverage for the executive. Likewise, the option price is often lower than the market price. Having both the flexibility and control to exercise ISOs at a favorable price, under favorable tax planning conditions, while having a definitive game plan (i.e. spend it for a major purchase goal, or diversify the investment portfolio) once exercised is the most desired situation. However, most decisions to exercise ISOs are done with less intention, and most options are exercised too early, losing that leverage the executive wields.

Mistake 2: Holding on Too Long

Restricted Stock Units (RSUs) have gained popularity as a preferred form of compensation, and are more generally more common than stock options (ISOs, or NQSOs). Likewise, RSUs typically have an immediate value, whereas stock options have zero value if the market price of the underlying stock is less than the grant price. However, the executive can often hold on to the RSUs too long and risk eating into her award. That is because RSUs are typically taxed at vesting of the stock.



Whether the stock goes up or goes down upon vesting, the tax on the RSUs is a done deal. If the executive holds onto the RSUs, the stock does not have the same time or price leverage that options carry. And in the worst case, the stock value goes down, and the executive sells the stock at a lower price, yet still paid the higher tax at the initial vesting. This is a lose-lose proposition. Company Stock may be a great way to build wealth, but can be a risky way to keep the wealth.

Mistake 3: Missed Opportunities to Save on the Tax

New executives upon hire are often granted generous compensation packages, but in the excitement of getting off to a good start at the new company, they often forget to take action on their equity grants that could save significantly on taxes. Some companies offer an 83(b) early election provision on their stock grants. However, these 83(b) election opportunities have very strict, time-sensitive deadlines to them, or the executive loses this opportunity. In fact, the 83(b) election requires the executive to make this decision within 30 days of the grant date. In essence, the executive is electing to pay the tax upon the grant of the stock, even if the stock has not yet vested. The 83(b) election enables the executive to elect to tax the current value of the grant now as ordinary compensation income (at the executive's current Federal & State tax), so that subsequent growth would be taxed at capital gains at its eventual sale. Also note that the executive's accountant must file the election with the IRS within the 30 days, and the executive will have to pay the tax on the grant this year.

Mistake 4: Not Having a Clear Plan Upon Sale

Although the timing of exercises and sales of stock grants can be managed, sometimes the executive is restricted from proactively managing her own stock because the executive is considered an "insider" by the SEC. Instead, the executive is forced to abide by a pre-defined disposition plan through a 10b5-1 plan. 10b5-1 plan trades are made according to the plan parameters and can be executed even during a company's closed trading window periods. But our firm sees more often than one would expect that these executives are sitting on substantial amounts of cash, not only for months, but sometimes for years! Simply put, it's either because the executive has forgotten to take action on them, or simply does not know what to do with the cash. Having no clear plan – whether it is to spend the cash to meet a major purchase goal, or re-direct and diversify their investments – can limit the executive's ability to fulfill to meet her financial goals.

Mistake 5: Letting Tax Drive the Decision

Most interestingly, in our experience, the initial conversation with the executive often revolves around the tax impact of an exercise or sale. Though the tax impact is important, our firm's viewpoint is that the tax should not drive the decision to exercise or sell! In fact, our firm believes in an alternative decision-making process:

1. What is the measured risk of the current stock holding? Even if the stock has some upside, what could the executive be giving up (e.g. fulfilling another, more immediate short-term goal) by holding onto the stock? The performance return of the stock is important, but understanding at what expense (i.e. the risk) is just as, if not more, important in evaluating the stock.

2. What alternatives does the executive have with the stock? Does it make sense to hold onto the stock, or sell to meet a financial goal? If the executive holds onto the stock, are there ways to protect the stock (e.g. margin, hedging, etc.)? Understanding the pros and cons of the various alternatives is important. Oftentimes, it won't be just one strategy, but a combination of various strategies.

3. Only until understanding the measured risk and the alternatives, then the executive can definitively evaluate the tax impact of a decision, and create a plan on how to mitigate any projected taxes.

Mistake 6: Thinking Complex Strategies Best Solve the Problem

When reviewing an executive's current plan, our firm often comes across highly complex (e.g. lots of moving parts with extra costs associated with them), or highly risky (e.g. high audit risk) strategies or "tactics" in an effort to save on taxes. This observation cannot be understated or overlooked. This complex maneuvering or tactic is often sold as a "tax loophole" or "tax haven," pitched by an outfit that is selling this concept. Or perhaps, they read about it in some general research over the internet, or a "successful" colleague of theirs shared some high level advice over the water-cooler. The simplest management techniques are usually the best, and should be pursued first. They are fastest, cheapest, have the least regulatory constraint, and often, the least audit exposure. Remember – "just because you can, doesn't mean you should!"

Mistake 7: Letting the Stock Drive the Career

An intangible, and subjective, factor to consider with the stock is the alternative "career risk" that the executive may be foregoing by holding onto the stock, or by staying at the company to wait for the stock to vest. How much extra salary (i.e. "extra cash," not necessarily company stock) could the executive be giving up to maintain those options? If the executive's career market value is higher elsewhere, is the executive better off leaving the current employer (and leaving any unvested shares), and saving and investing the extra salary? That is, evaluate the Total Career Earnings versus the potential stock appreciation.

When working with executives, our work typically goes beyond the tactics and strategies of sophisticated investment management or financial planning, but rather *life and career planning*. Ultimately, the executives our firm works with are highly intelligent, successful people, with families (partners, spouses, children, aging parents) and real-life problems. As a result, advising executives on their stock goes beyond the analytics.

Our firm does our best work with clients who fit one or more of the following:

- Talented, Highly-Sought-After "Creatives" and Executives in Technology, who have a desire to "get it right" the first time, and value the flexibility in their career and their family, so that they can move forward with confidence no matter what direction their life takes.
- Have complex Compensation and Benefits Packages, and seek assistance to make sure they are getting the best package they deserve.
- Have concentrated stock holdings (e.g. stock option grants – ISOs/NQSOs, restricted stock units – RSUs, and stock appreciation rights – SARs, etc.)
- Desire a meaningful commitment (e.g. intention, desired goal, or a plan already in place – e.g. Schedule A Itemized Deductions – Gifts to Charity, Donor Advised Funds, Charitable Trusts – CRTs CLTs, etc.) to giving back for Social Good and Social Responsibility.
- Constantly seeking to improve or refine one's own situation, and open to new ideas.
- Understands that time (and the proper usage of this time) is probably their most valuable asset.
- Appreciates and values expertise through counsel, and aims to build a collaborative relationship with their existing advisors (e.g. attorney, accountant, etc.).
- Above all, our clients are intelligent, open-minded, and display the highest character & integrity.

If you would like to understand how to manage your equity compensation packages more effectively, please visit our web site, www.ChromeAdvisors.com.

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