UNWINDING A CONCENTRATED STOCK POSITION

A chapter from "A Business Class Wealth Vision"

VIZIONARY
WEALTH MANAGEMENT

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Unwinding a Concentrated Stock Position

Last chapter we talked about sudden wealth syndrome and how this can affect behavior related to your investments. We also discussed the idea that, quite often, those suffering from SWS have significant single stock risk in their portfolio. In this chapter, we will discuss specific strategies for unwinding that concentrated stock position within a portfolio and thus reducing the risk associated with too much exposure to one security.

A concentrated stock risk emerges most often within a client's long-term incentive equity. This is usually some combination of exposure to stock grants you have received that have vested and accumulated over a period of years combined with stock option equity that has arisen as your stock options have vested and the company stock has continued to rise over time.

In this chapter, I am going to assume you are of sound mind and are not suffering the emotional conflicts and overconfidence associated with SWS (as we discussed in the previous chapter). I will cover alternatives for unwinding and planning around a concentrated stock position. The simplest answer to reducing your exposure is to just sell the stock or exercise the options. This is usually overly simplistic, as it ignores where the stock may be in its trading range,

any tax liabilities associated with various tax lots, or any blocks of stock or options you own, etc.

Understanding the tax consequences of selling shares or options is crucial to successful planning.

When you are issued stock options, most of the time these will be non-qualified stock options. As we have previously discussed, you are granted a window of time from the vesting date to the expiration date to buy the stock at the strike price (exercise the option), and your profit is the difference between the exercise (sell) price and the strike (buy) price. Most of the time you can do this as a "cashless exercise" where you don't have to actually put up the money to actually "buy" the shares. However, there may be situations when you do want to actually buy the shares. I will outline a few below:

- If you are exercising incentive stock options, there may be tax advantages to you actually fronting the money to buy the shares and then holding those shares for the requisite amount of time to avoid income tax liability on the gain, paying long-term capital gain tax rates on the gain instead. Consult with your financial and tax advisors on this strategy.
- If you are leaving a company (voluntarily or not), you may be under a forced timeframe to exercise all of your options if you feel the stock is severely undervalued. This may be a situation when you might want to scrape together the cash to exercise your options by buying the stock and holding it until it reaches the price you want. I have helped a number of clients with this over the years. It is a serious discussion and can raise the concentration risk in your portfolio significantly for a period f time but may pay off if your instinct about the stock being currently undervalued is right.

- You may be working for a private company, and you anticipate the stock will go up substantially in the years to come. Exercising the stock options you have by buying the shares today will expose you to income tax liability on the difference between the strike and exercise prices today, but all future gain on the shares you own will now be taxed at capital gains rates. This strategy can be particularly valuable for leadership team members who anticipate having significant exposure to the stock over time. You may be able to exercise your options when the share price is being measured in quarters and dimes and reduce your future tax liability on the growth of those shares. This adds risk to your strategy but is something to consider with your advisors in the context of your overall portfolio risk and growth strategy.

Your stock grants will be taxed as income at the time they vest, and the company traditionally will sell off a portion of those shares when they vest to prepay the tax liability. This often creates some of the most frustrating tax situations for my clients. For example, if you have a $200,000 block of stock vest, the company holds back maybe 25 percent (so, it sells 25 percent of your shares) to pay taxes. At the end of the year, you may be left trying to figure out why you owe the IRS $50,000. The answer is, that stock grant put you in a higher income tax bracket for both state and federal taxes, and the IRS applied some Medicare surtax on top of the marginal tax bracket so you owe 50 percent in taxes on that $200,000 in stock and your company only held back 25 percent on it. I hate these conversations, but they are a natural offshoot of working with successful people.

As I have said before—the government loves your W-2 income because they get to keep so very much of it!

As you review your exposure to your company's stock and plan to reduce your concentrated position, you will want to review your "tax lots." Let's say you have been working for the company for ten years, and you have received some stock options and some grants each year over the years. You know you need to reduce your exposure, but you will be triangulating against a number of factors:

- You are triangulating against the expiration date of your options. An option usually has a life span of ten years from start to finish. Part of that time is the vesting period, so let's say your options vest 25 percent each year for four years, and you were granted 4,000 options. Each year, as your options vest, you have the right to buy the shares at that strike price, but all of them expire on the tenth anniversary of the original date of the option. If you have been working with a company for a long period of time, managing which sets of options you are exercising from which dates becomes an important part of the math. You typically don't want to hold on for the last few months or weeks before exercising, as this exposes you to the risk the stock may drop for an unforeseen reason and wipe out your equity in that set of options without time for the stock to recover before the expiration date.

- You are triangulating against the additional tax liability you are exposing yourself to and the percentage reduction in your overall exposure. When you have eight different years of options at eight different strike prices, your goal is to reduce the dollar amount or percentage of overall risk. This may mean exercising just a few options with very low strike prices or exercising a whole lot of options with very little equity in them because these are the options about to expire.

- You may also be working on the income tax liability associated with exercising your stock options vs. the capital gains tax liability associated with selling off some of your vested stock grants (actual shares).

Each of these individual blocks of shares or options is a different "tax lot," meaning each has its own unique tax treatment. You want to be strategizing with your financial and tax consultants and integrating some of the other strategies we will discuss to manage your tax liability.

There may be a year where you are going to have a huge tax liability, but that year you are also significantly reducing your concentration risk within your portfolio. Paying known amounts of taxes and managing that tax liability while you reduce the unknown risks associated with the concentrated stock within your portfolio is often an acceptable trade-off that may need to be made at some point—or at multiple points—along your journey. Make sure you are working with experts to manage this correctly. If you don't manage your tax lots, most firms will operate on a first-in-first-out basis, and you may pay more in taxes than you needed to.

There are a number of specific strategies I regularly use with clients to manage the tax liability associated with reducing concentration risk within their portfolios. Some are complicated and add significant complexity, costs, and administration. Those strategies, such as charitable remainder trusts, charitable remainder unified trusts, family limited partnerships, and others are more regularly used for managing illiquid assets of eight figures or more. I have

been involved with a number of these transactions, but they generally fall beyond the scope of this book and the more likely scenarios you and most of my clients will encounter. So, for the sake of this book, let's stick to what we might call the "regular" strategies you might use to manage your tax liability. These "regular strategies" include:

Tax lot accounting/management: This is the process of managing the overall size of an individual position within the overall portfolio and managing each transaction in a tax-efficient manner. This may include choosing which sets of options or shares to exercise or sell based on each one's tax liability. This may include harvesting losses in other parts of the portfolio to help offset gains to be realized when long-term incentives are sold off. Tax avoidance is illegal; tax management is not. We never want to even get close to breaking the law, but we certainly want to use every tax minimization strategy we can to help you keep more of your money. After all, it is *your* money.

Using an exchange fund may be an effective way to manage your exposure to an individual stock. An exchange fund is made up of many blocks of stock that have each been "exchanged" for shares in the fund. Let's say there are 100 executives at 100 different companies who each have $1 million of highly appreciated stock. They all face concentration risk within their personal portfolios, and they each face significant capital gain exposure if they sell their shares on the open market. Rather than selling their shares, they exchange them into this fund for a share of the overall proceeds of the fund. Current tax law (in 2020) allows:

a) the exchange does not trigger the capital gain liability as a sale of the shares would,

b) the cost basis they had carries over to the fund, and

c) they may withdraw their cost basis over time (subject to imitations) still without recognizing the capital gain liability on the gain in the stock price.

This might help solve a lot of problems for you if you are highly exposed to your company stock and face both concentration and capital gains tax liability risks as you try to reduce your exposure. There are a few companies who provide this kind of vehicle. Generally, they will only allow shares of companies with a $5 billion or greater market cap and a certain amount of shares from each company to exchange into the fund. This is done in an effort to protect the fund from itself becoming overly concentrated, and in an effort to keep the fund filled with established (blue chip) companies, not companies which may have severe volatility risk and/or the systemic risk often associated with smaller cap companies.

It is very important to understand the proper use of an exchange fund. Recently, I had an individual call me to tell me he met with the advisor from the company that is the custodian of his long-term incentives, and he expressed his frustration over his $100,000 tax bill from last year (his income had risen over $500,000 compared to the previous year, and his company didn't withhold enough on the stock shares that vested). The representative told my client that if he would put his $600,000 of company stock into their exchange fund, he would eliminate that income tax liability in future years. Apart from the fact that company's exchange fund holds all assets for at least seven years (which was not acceptable to him), the fact of the matter was my client had almost no capital gain exposure in that $600,000 of stock, and, with a net worth approaching $6 million, he didn't face a severe concentration risk either. I believe this was an

example of an inexperienced financial advisor trying to use a complex product in a way it was not intended. The exchange fund would have done nothing to help him with his income tax bill that was generated by his W-2 income and would unnecessarily tie his money up for the next seven years, all without even helping him avoid much in the way of capital gains tax liability.

On the other hand, one man left his company some time ago with a large block of options. He exercised the options and bought the stock, paying income tax on around $3 million of income. The stock has now quadrupled in value from the time he bought the shares, and they are sitting on close to $8 million in equity after he divested some other large chunks of the shares over the last year. He is highly exposed to capital gains but doesn't really need liquidity out of the stock. He works with an exchange fund provider to exchange around $5 million into the fund with a plan to withdraw the basis from the fund over the next ten years. This man will ultimately not pay capital gains on the exchange. He will get the basis out over time and use those funds in other parts of the portfolio for liquidity, leaving 100 percent of the gain inside the fund over the long term and drawing just the dividends out each year for cashflow. An exchange fund can be a powerful tool to solve the right problem in the right situation. Done poorly, though, it can also be misused to solve problems you don't have and create new ones you don't need.

Donor-advised funds are what I call "A Poor Man's Family Charitable Trust." The reality is, many families are now unwinding old, very complex, expensive, and administratively burdensome family charitable trusts in favor of donor-advised funds. One of these funds operates like this: You receive a full charitable tax deduction when you contribute funds (this could be in the form of cash, stock, property, etc.) into a donor-advised fund. The fund itself

is a charitable entity and provides the charitable deduction when you donate. The assets are then held in trust with the donor-advised fund until the donor advisor (you) direct the charity to distribute the funds to other charitable entities to be used by those charities in pursuit of their individual missions. Think of it this way: You may have a United Way campaign at work where you are encouraged to contribute, and you may designate the gift to a local food bank, homeless shelter, etc. In this situation, United Way is effectively acting as the donor-advised fund—holding the donation for you until they directly pass along the gift. I often recommend using a donor-advised fund to help you manage long-term charitable planning in coordination with your long-term personal goals, where appropriate.

For example, let's say we are trying to reduce your exposure to your long-term incentives by exercising $1 million of equity out of them. You have $1 million in equity in stock options, and you have another block of stock grants that is worth $1 million and has a $200,000 basis. After reviewing your taxes and future goals, you want to be in a position to give $30,000 a year to charity throughout retirement. What we may do is something like this:

a) Exercise $800,000 in the equity of the stock options, subjecting them to your marginal income tax rate of, say, 40 percent;

b) Pick the lowest cost-basis positions from your stock grants and donate $500,000 of stock to a donor-advised fund in your name (you choose the title).

We have done a few things here:

1. You owe income tax of 40 percent on the stock option exercise ($320,000).
2. You avoided capital gains taxes on the "sale" of the stock grant (20 percent on the $400,000 in gain = $80,000 tax "savings").
3. You have a $500,000 income tax deduction based on the gift of stock to the fund (saving $200,000 at your 40 percent marginal income tax bracket).

You have reduced your $320,000 tax bill by $200,000 due to the contribution and legally avoided another $80,000 in capital gain taxes because you donated $500,000 in stock instead of donating cash to the donor-advised fund. You now control almost all of your $800,000 in cash from the exercise of the options; you control the future disbursement of the $500,000 to charities of your choice over whatever timeframe and in whatever amounts you choose, and you have reduced your $2 million concentrated stock position by $1.3 million. The stock can be sold off within the donor-advised fund to diversify risk without incurring any tax liability because it is being done inside a charitable entity. This is an example of how a donor-advised fund can be a powerful tool to help advance you toward your goals on multiple fronts at the same time.

Integrating Estate Planning with Your Long-Term Incentive Planning:

Your estate plan needs to be regularly updated as you progress through various stages of life, achieve milestones, have kids mature,

etc. Integrating that planning with incentive planning can also be a powerful way to manage assets between generations.

Under current law (as of 2020), each person can pass $11.58 million on to their heirs without incurring federal estate taxes. There are a number of other reasons to integrate the use of trusts into your estate plan, such as avoiding probate, reducing state inheritance taxes, and shortening the wait for your heirs to take control of your assets after death.

Few of us will actually run into the specific need to do really complex planning to reduce federal estate taxes, but I have two thoughts here: a) the law as it presently is written expires in the not-too-distant future, and we cannot predict which direction political winds may blow as that window closes; b) as time marches on, inflation, devaluation of currency, and other factors make today's "big dollars" tomorrow's average dollars. Therefore, it behooves us to be aware of strategies you may not need today but which you may want in your toolbox tomorrow. Your situation will be unique and your advisor, attorney, and CPA should all be in on the conversation related to setting your estate plan up to minimize taxes and distribute assets in a manner consistent with your wishes.

A number of years ago, I knew a man who left big pharma to take a role at a start-up as CEO. He had high hopes for the company, and part of the negotiation he did on the front end was buying shares ofthe company's stock instead of being granted options. He paid something like 1/10 of a penny per share for the stock. The hope was that the shares would be far more valuable (likely hundreds or thousands of times more valuable) as the company proceeded with their business plan. He worked with licensed professionals to set up trust accounts for each of his children and "gift" some of his shares

into each of those trusts with each of his children named as beneficiaries of the trust. By gifting the shares today, he gives up any and all future control or ownership of them to benefit him and his wife. However, the future potential to reduce his estate tax liability is huge. This use of a trust and gifting laws can allow you to pass on to the next generation assets at today's very low price and allow that explosion of value to occur inside the trust (outside of your estate), thus avoiding estate taxation on the future transfer of those assets. That man is the trustee on the trust, so he controls the investment strategy, any distributions, and so on. He has named a successor trustee to take over if he is no longer here, and the trust itself has provisions for providing for his children and their children so long as assets remain over time.

The goal in reducing concentrated stock risk is to reduce the volatility risk of that stock within the overall net worth. The purpose of reducing the amount of stock you have exposed to an individual position is to reduce the possibility a correction in that one position may derail your longer term plans or lifestyle goals. Far too often, I see people who allow one stock to become such a large percentage of their net worth that they suddenly think they're financially independent and their problems are over. That may be true today, but the turning of fortunes in the pharmaceutical industry being what they are, if that stock corrects, you may end up having unmet expectations and unachieved goals because you allowed concentration risk to run rampant within your portfolio.

Before I end this chapter, I have to address one other thought: Often I will have someone point out that most of the world's billionaires are over-concentrated in one stock or the stock of the companies they control. That is very true. However, if you are worth $1 billion and you have 90 percent of your money in a single stock, think about

the size of the 10 percent that's left. The journey from where you are to where those rare individuals are is filled with lots of risk, including substantial single-stock risk. My guess is most of those billionaires have their "walk-away money" in something other than their own stock. Virtually all ultra-wealthy people do.

It's my job to help you manage single stock and concentration risk as a portion of the overall portfolio and bring creative strategies to bear so you can take advantage of tax deductions, increase diversification within your portfolio, and stay on track with your long-term strategies. That way one stock correction doesn't move the end zone for your goals.

About the Author
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Wayne Wagner Jr. is president of Vizionary Wealth Management; an Investment Advisor Representative through WealthPlan Investment Management, LLC, an SEC Registered Investment Advisor; and holds insurance licenses in multiple states. He holds the Chartered Financial Consultant (ChFC) designation and is committed to practicing with the highest degree of ethics and honesty.

Wayne is a member of the Society of Financial Service Professionals and the National Association of Insurance and Financial Advisors. He has guest lectured at a number of regional universities and participates in many industry meetings and conference panel discussions.

Wayne is a sought-after resource for his high net worth clients to problem-solve and strategically plan complicated opportunities pertaining to their businesses, careers, and estates. Wayne is located on the east coast but is notice-filed and has client relationships in several states around the country.

When not busy helping his clients pursue their financial goals, Wayne mentors young people to become good stewards of their time, talents, and opportunities. He starts businesses to help fund non-profit organizations he is supporting. He volunteers as a financial advisory committee member at Sovereign Grace Church and counsels a number of other non-profit organizations regarding their own strategic planning initiatives. Wayne and his wife, Mae, live in Pilesgrove, New Jersey, with their children, Ciera Joy, and Bryce. Their family motto is, “We’re Wagners—we do big things.”

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We hope you have enjoyed this sample of *A Business Class Wealth Vision*. If the information resonated with you, and you'd like to employ a comprehensive, personalized approach for your retirement strategy, give Wayne Wagner Jr. and VizionaryWealth Management a call, and we'll see what we can do together.

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