Andrew 0:04

Hello, and welcome to the JGUA financial commentary podcast. I'm your host, Andrew Baron. And in this episode, we have a previously recorded webinar presentation with William Post, and Jason Nickerson about equity compensation. In the presentation Will and Jason discuss some basics about cash flow and the markets and continue on into different aspects of equity compensation, including managing some of the risks. As you listen, you may have some questions come to mind, please email info@jgua.com to talk to an advisor.

But first, a short disclaimer. The contents of this podcast are strictly for informational purposes only, and nothing said should be taken as investment, tax, or legal advice. Any strategies discussed may not be suitable for the listener specifically and JGUA encourages consulting with your advisor before implementing any strategies to ensure they meet your individual objectives.

This webinar was previously recorded on September 3, 2020 and the information was accurate at the time of the original presentation. Please enjoy!

William Post 1:08

Jason has been with our firm here at John G. Ullman & Associates for over 23 years. He's our executive vice president is an Enrolled Agent has his CFP® designation, and we'll be sharing his insights on today's topic discussing equity compensation optimization. The format of this presentation will include basic strategies at the beginning. And we'll get more specific as the presentation progresses. Jason, let me ask you, where do you start with these discussions at a basic level?

Jason Nickerson 1:41

We have to boil this back down to using your key word basic. And it's interesting when we start doing this we really start in the area of the monthly cash flow. It gets people to a level nowadays that they can focus on and understand better than the longer term annual or even three, five, ten years down the road. What's interesting is that the number of people that haven't done this exercise, even in normal times, where they understand what is going out versus what's coming in.

Let's start categorizing things, really between what is necessity, and what is just the extra. So monthly cash flow is a key point to understand where you are what's coming in what's going out. A lot of times, we'll find that maybe they're not in as bad a position as they initially think they are. We may feel like we understand what our cost of living is but we don't understand what necessities are. And like I said it is interesting, people think that they understand necessities versus extra. And then we get into it. And they really kind of don't, once we get through that exercise, we work with our clients, and even clients kids to some extent, to get them set up and we do that through a progression of action items. One of them will be emergency fund. This is one area we focus on with younger folks just kind of starting out to help them build and understand what emergency fund is for

. But we don't necessarily understand what to really use it for. We just think it's the rainy day fund. Well guess what if cash flow is a little bit in crisis mode, this is what it can be used for. But what we want to make sure it's not being used for is okay, well, I'm covering necessities, I'm going to use emergency fund to take the vacation we wanted to take but my pay has been cut, I can't pay for it that way. Let’s not go there necessities are being covered, then the emergency fund is there for that.

Once we understand inflows outflows and where gaps can be filled from we do feel it's important that communication is had with family. Communication is a big deal in a situation like this to help everybody understand like, hey, you know, this is a either a short term, midterm, long term permanent adjustment we're going to need to make and everybody being on board, the last thing you want to have happen is try to keep that close to the vest and pretend that everything is okay And it's really not. The so we do feel that communication with the family and changing behaviors may be necessary once we understand the details.

Tax planning becomes important. I think people forget about this because they're looking at cash flow and there's varying adjustments that happen that hey, if income is down, perhaps I can adjust withholdings, or if I'm if I'm in a position, I'm making estimated tax payments, maybe I can reduce those or cut them out altogether. This is something we discuss with clients on an ongoing basis is how they handle taxes. Are they getting a monster refund in April? And why are you giving your money to federal and state governments interest free and that's another good way to maybe fill a gap is if you're used to getting a big refund, let's not get a big refund anymore.

Let's put that back into the monthly cash flow. Like you said, Will, this is a good basic starting point. We focus short term for the short term, but then we try to get us refocused back on some longer term. What are the opportunities that we can exercise? Given the current state of affairs both what's happening to us personally and sort of in the in the business environment.

William Post 5:01

Your points were very short term focus. But we all know that there's a need to have a balanced approach to short and long term objectives, though, how do we do this? How do we reset our goals? What is the market telling us so that we can properly gauge our next step?

Jason Nickerson 5:18

Yeah, I think so you're using some great keywords for me Will. “Basic & market”. As we move on to this discussion. There’s so much debate that can happen. I was talking with someone the other night, they said, Well, we've always learned that the stock market is a leading indicator and that's a good thing to know here in the growth versus value debate. I think this is one piece of what we're saying and market performance Right now. There's been a deviation between these two strategies. Our research team drew a chart going back full history of the firm, 40, 40 plus years, and in the history of the firm, it may have happened previously but we're only looking at that time period. There's been a significant deviation between growth and value where growth has significantly outperformed value. The turn of the century is one seems to line up with the dotcom bubble. And right now about 2017 is where it started, is where there's been this major separation, otherwise, they've either been closely tied, or value has somewhat outperformed in in a longer term performance measurement.

So what does that all mean? Well, let me give you a little more detail that if you take some of the most popular momentum growth based stocks out of the stock market, right now, you're going to see a drastic decline in what the stock market performance has been. What are those stocks? I mean, I would give you five guesses and you would probably only need five guesses, right? It's Facebook, Amazon, Apple, Microsoft, Google. Those are the five stocks that are really driving the market growth, if you take those out, performance is much, much weaker, just depending on the index that you'd be looking at. I don't want to tie us to any particular index but just from a broad common standpoint. This is not a total stock market performance that we are seeing this is a very small group of companies that are really driving the market forward.

And so these types of things, all of this, both economic conditions, uncertainty of where we really are in the pandemic, and the outcome and recovery from that and you know, these very specific market conditions and investment styles, this is what has us a little bit concerned. But it doesn't mean there isn’t opportunities out there when we package all of this together into one conversation when we talk about both personal impact market and economic impact. So we do think that there are some opportunities out there that we want to talk about today.

William Post 7:43

Let me ask you, with these market conditions in mind, how do you anticipate one should plan their personal financial planning measures for their own compensation benefits? How does this trickle down?

Jason Nickerson 7:57

So I think there's two main areas we want to address today. I do believe there are opportunities and probably some necessary moves. One is on retirement benefits. So it's a big category. Retirement benefits can be pensions and retirement savings plans and things like this. Most people today don't really have traditional pensions anymore, there's still a few lingering out there. So we're really looking at is how do we optimize, capitalize, on what we are provided by employers. One of the things that we're seeing and pullback by companies is not just compensation, like salaries and bonuses, but we are also seeing removal of matching programs out of out of retirement plans.

And so out of that, we're getting a lot of questions of should I continue to contribute to my retirement plan? Once we get through some of the basics, if there's room to do so the answer is absolutely yes, every day and twice on Sunday. And here's the reason why is a couple of things. One, from a psychological standpoint, there's a number of things that happened to us if we pull back out of our savings, that may provide some short term satisfaction and relief on the cash flow but we're not getting anywhere towards the long term goals. One of the things that happened a few years ago in 401k plans was a significant nudge, where companies were rolling out 401k plans and saying “here, you can contribute to this”. And then they saw a participation that wasn't at a level they wanted to so now they moved it to, we're going to automatically enroll you. And what they found was when they went to automatic enrollments and maybe even automatic contribution increases, people weren't making changes. They were just letting it ride. They were letting those things happen.

So think about this now. If cash flow is an issue and you totally eliminate any contribution to an extreme. What do you think would happen when things return to normal? Will you remember to kick back up your 401k contribution? We are all so busy. That's probably the last thing we might even think about unless we are really tied into every financial detail. We try to get people to continue to contribute even if there is no matching. But how do we best maximize the opportunities knowing that the company's not giving us any money?

Well, I mentioned that tax planning would be key given compensation reductions. I think it's also key when we talk about long term approaches, if you sit back philosophically, why am I putting money into a 401k plan on a pretax basis, which most of us are, unless we have a Roth 401k, but let's just stick with what we have is a plan that allows us to contribute on a pretax basis.

What our goal is long term is we're putting money away at a higher rate so that when we retire, we expect to be at a lower tax rate, and we're going to take the money out or lower tax rate. That’s the tax savings. It's not just tax deferral, but there's potential tax savings in the brackets. What if this year, you are actually in a lower tax bracket, because compensations down: salary and bonuses. There might be an idea or an opportunity for you to say, if a company allows me to put money in an after tax basis, then maybe I want to do that, called a “mega backdoor Roth”. It's a funky name. But a lot of people that we work with, don't qualify to put money into Roth IRAs, incomes too high, they have options, other work other places, whatever the case may be, but 401k’s tend to allow people to contribute on an after tax basis, even if it's not a Roth 401k. In this year, if your tax rate is low, and you're thinking, well, it's low, and it's going to be this low in retirement, then I lose the tax benefits of putting away pretax and taking out at a lower rate. Putting money in an after tax basis, we're equalizing the tax rates now and later.

When we retire, and we can roll the 401k out and split it up, we can take that chunk of after tax money that we have built in there, and we can take it directly to a Roth IRA. There's a lot of details around this so I would say got to have a good consultant or good advisor by our side in order to do this. But that's something to think about when you're thinking about contribution. Continue them if you can, continue to them pretax, if it makes sense, but also look at potential after tax contributions. This is also a good environment with the market, like we just said, being deviated, it seems from what economic reality might be, I feel you have an opportunity to really take a look at your 401k allocations.

Reflect back on how you felt back in March when the market had sold off 30% and were you really panicking and watching the losses in your 401k? And how did you feel? Let’s not lose that feeling? Okay, because that feeling right there while it's going to come sporadically and everyone thinks, well, the market is always going to be higher, Well, that's true if you draw it out over a long period of time. But we don't always live over that long period of time. We don't spend over that long period of time. Now a good time to say how I felt, and maybe I was too aggressive back then. I've regained some of that value and maybe now's a good time to take some money back out of equities, and rebalance. The markets kind of giving us an opportunity. I think, for that.

I want to come back to the mega backdoor Roth for a moment. Perhaps you've been one that you have been putting money into the 401k on an after tax basis. This is a great opportunity, you can roll the 401k out. And you can get that money in that after tax money into a Roth IRA and get that growing in a tax free basis. There's something you can be doing now from a future saving standpoint to set you up for it. But if you have been totally removed from the company, your choice, there's whatever, maybe you have this available to you. The last point I wanted to make an impact on retirement benefits is net unrealized appreciation. And again, this is similar to that mega backdoor Roth. Is there something we can do now looking forward? Is there something we can do now based on our situation?

A little bit of background net unrealized appreciation has to deal with having company stock inside the 401k. If you don't have that tune out for a minute, maybe you want to listen in just because you're interested. What net unrealized appreciation allows you to do is if you own company, stock, and your company stock inside a 401k. When you totally roll out and exit the plan, you can extract the company stock from the plan, okay? Put it over in another brokerage account, whatever, but you're removing it from the 401k removing it from the IRA rollover. What are the implications because that sounds a little too good to be true?

When you take that out, the company has tracked your cost basis on the stock. Cost basis being different than value. So let's paint an example. You own 100 shares of Company stock inside the 401k and you paid $1 for it, it's now worth $10. When you exercise this option and extract the company stock from the 401k you pay tax only on the basis of the stock. Okay, so the $1 times 100, 100 bucks, that's your tax liability. That's the income for the year and apply your tax rate to it. But it's worth 10 bucks a share so $1,000 to a difference between 100 and 1000. Give $900 of gain. Well that's got to be taxed somewhere. When you sell the stock, it can be sold day one or 10 years from now, you will pay capital gains tax on that gain under this option. What is the planning either now looking forward or now because you're rolling monies out?

Well now looking forward is be careful when you're doing 401k allocations. The local company is near and dear to us, Corning Inc., they don't have an option for you to be buying into the company stock anymore. So if you already own it in there, you want to be careful about reallocating too much because you may be eliminating this opportunity, this great tax opportunity down the road, if you're in the situation where you have retired or left the company and you want to exercise this, just be aware, again, you need to have a good adviser by your side to make sure that A) it's done and communicated to the company correctly when you're doing the rollover. But also the tax reporting is done correctly come time to do your tax return. But it's something you want to really take a look at, you need to know your basis versus value. Again, going back to if income is down, then we may be okay for you may be a good opportunity for you to take on some other income in this way.

That's kind of a good transition. There's some you know, we're going to talk about in terms of another way, maybe some opportunities there for you, which is adding income, and we’re usually trying to defer income or avoid income. But if our tax rate is down, it might be a good year for that.

William Post 16:20

These are retirement consideration. But what about like equity positions and exercising options and things of that nature?

Jason Nickerson 16:27

The other big topic here to think about is, what is my equity compensation? What is my exposure? And how do I manage that, you know, right now? The first thing that in talking about equity compensation and exposure to company stock, people tend to be very narrowly focused on their exposure and I want to express that, I'm telling you that everybody under estimates their exposure to their company. Especially if you're an equity holder in some way shape, or form. Stock options, restricted shares, 401k shares, whatever the case may be.

If we were to bring it to an example to us locally, again, Corning. Let's play out all of the ways that the business conditions at Corning kind of impact those we talked about already, your salary, your bonuses, and the value of the stock itself. But what about if the company's not hiring and letting people go? If it during good times, the company is hiring, let's say and they're bringing people in? What do you think happens to home values, this is a, this is traditional economics, sort of 101, supply and demand of housing. If the company is hiring people and bringing people in from out of the area, value of our homes goes way up. Okay? Now think of reverse is if they're letting people go, and the same people are not from the area and they are going to move, then the value of our homes could drop. Now, I don't want to get into the dynamics of the real estate market right now because there's another area that has just seen an explosion in terms of sales and opportunities there. But if a company is not doing well in the community around it, it's not just our paychecks, not just the stock price, but there's a lot of other things. So this is a good time to step back and think that way and say okay, what should I do to kind of manage my overall exposure? Well, one of the most direct easy impact areas is the equity compensation you have.

So if the company's stock price, relative to where it has been and relative economic data is still good, whatever that means. It's still a decent price and you're comfortable with it. Then let's go in and let's start looking at our vesting schedules and our expiration schedules on restricted shares and stock options. Again, like I said before, it's a different tax year this year, because your salary compensation, your bonus compensation is down. So maybe it's a good year to incur some additional income.

If you drop down a bracket, maybe you fill up that bracket, maybe you fill up the bracket you're already in because you're just you're losing income in one sense, but you can gain in another. When it comes to managing equity comp for us a couple of things I want to point out. Let's talk about vesting. Vesting when I when I say that I'm referring mainly to restricted shares, although investing in stock options happens as well. We're typically advising clients at the prices right, when those shares vest to you and you have the ability to transact with them, think long and hard about doing something right away with a majority or all of it. And here's why. When those vest to you, you pay taxes that tax year. If the market does start to line up with economic conditions, let's say in the next six months, eight months, you will pay taxes on a value that may not be there in the future. So you're going to pay taxes at a higher level and sell at a lower level.

Potentially, we generally look to cash some of those things out majority or all of them. Again depending on tax situations, investment conditions, etc. Expirations. This is one with stock options that we get caught up in. we are typically advising clients to keep their stock option expirations out two or three years, and certainly with some companies whose stock price maybe is held up or has recovered, this will be a good time to start cashing some of those out and pushing expirations out two to three years.

The last thing you want to have happen is let's rewind the clock to early 2020 and you have a dip in the market in February, March. And you had an expiration that you were hoping to January if we if we were if we had a stock chart up here. January in stock market was very strong. March is when we saw the big sell off. Imagine if you said oh, I think January is going to continue. I know I've got this stock option expiring in late March, early April, I'm going to ride this out. I bet try and get another dollar or two per share. And then the market sells off. And now maybe it expires out of the money. Horrible situation.

So typically telling people get those expirations out there, don't wait to the last minute because no one has a crystal ball in regards to the market. Blackout periods and 10b5-1 plans with blackout periods if you're in that situation, if you are at a level where you might be subject to windows, of selling transacting chairs, we're typically advising clients on a regular basis, utilize those windows every time you get one. The reason is, you again you don't know what the next window is going to bring you in terms of stock price. So it's best that if you can say every window, I'm going to do something as long as the stock price is reasonable exercise options, sell shares, etc. That is a good expectation to have. But how can you manage out of it? Many executives have potentially heard of something called a 10b5-1 plan. This is a plan that allows you to pre plan your transactions, especially if you're subject to Windows so that you avoid any issues with nonpublic information. It allows you to set timing price etc. And the last thing you want to do is then be making changes in those. In what situations will those be good? If you need liquidity outside of company stock, if you are company stock heavy, and subject to blackout periods, you may want to consider one of these plans because it allows you to create liquidity.

You know, I think of the executive maybe that has, you know, been extremely loyal and continues to remain invested with the company through options through shares, etc. They haven't done much in terms of cashing out or taking out proceeds. And now they've got a child going to school and they were banking on some of this liquidity, but they're subject to blackout periods. Putting one of these plans in again allows you to along with a plan pre-determined timing prices, etc. to create some of that liquidity in the stock. And avoid some of the windows but it's a pre designed plan. But again, I think the best way to approach this is, to go through those blackout periods, and once you get into an open window, try to do something in every window to free yourself some of that exposure.

William Post 23:23

Here's a tax question. Our listener is wondering, am I able to harvest any of my losses I've experienced and put those losses towards future gains? How does that work?

Jason Nickerson 23:35

Absolutely! One of our favorite things to do. So what do we have? Well, we had maybe a poor performance here in some of the stocks that we picked, or ETFs or something like that. And maybe we want to reposition, maybe there are better ideas. You know, as humans, we tend to be loss averse. So the first thing we have to do is we have to get over that mental hurdle, that psychological hurdle of accepting the fact that maybe we have a bad stock pick or something that's going to happen everyone does it. We do it. But not every stock pick turns out that we make. But there's a way to capitalize on that little bit of misfortune, which is to sell it for a loss. Okay, did we totally lose all the money? Not necessarily that can help us out tax wise. So let's say we were fortunate enough to buy Amazon and we were unfortunate enough to buy Delta Airlines as two examples.

Well, if we decide Amazon's done great. I'm going to sell some take the gains put in my pocket. Delta has not done so well. I'm going to sell that and be done. We can take the loss from delta and offset it with gains and Amazon. Dollar for dollar. Okay? And there's a matching, you know, detail that goes on behind the scenes. But there is that capability. What if we don't have any gains? What if, what if, you know, we're just cleaning out some losses some of the bad eggs? Those losses can actually accumulate. And we can offset up to $3,000 of our ordinary income with those losses. So there's a real tax savings opportunity, not just against capital gains we may have been fortunate enough to obtain but we can also offset other ordinary income our salary or dividends, interest, etc. you can put on that line on the tax return minus $3,000.

What if we have more than that? Guess what they can carry into the next year. So if we max everything out with our losses, we've offset our gains, we've got more we can put up to $3,000. The rest of it can carry over and help us in the future with tax savings. So good question. This is yet another opportunity that can be highlighted, given, you know, a potentially negative situation, we can make the best out of it.

William Post 25:51

So the same listener has a follow up question that's on the opposite side of the trend. So that is what to do with losses. Now he has a gains question. Are there any strategies we can implement when we have appreciated assets?

Jason Nickerson 26:08

Yeah, great question. So the first thing I will say that I tend to tell clients in years, where there are good gains and markets doing well, and we're doing well, is if we're paying taxes, that means we're making money. And isn't that the goal? And then we're making money for something? Right? But the goal is to make money. Okay. So what strategies can you do to maybe lower the impact of some of those gains? Well, again, I think if you come back to losses, that shouldn't just be when the markets bad that it means some of us, you know, it's not all stocks do well, all the time.

So you want to look at your portfolio every year, certainly within the tax year. So you know, even November, December, as you get towards the end of the year, if you say wow, I've accumulated some great gains. Now, let me see what I've got in there. And I can take some losses. Here's the beauty. If you decide to take a loss on a stock to offset your gains, because you bet you've been fortunate to have some gains. But you really do like the stock, you think it's a good stock to own. You can rebuy it. I'm going to warn you, there is a carve out in the tax law, that's called a wash sale.

Okay. So we want to be careful of is, let's take our Amazon Delta Airlines example, again, this time, you know, Amazon has far exceeded and delta doesn't totally offset that gain. So we take the loss, but we do think delta will recover in the near future. There's a 30 day time period, where you can certainly sell a one day and buy it back. Okay. But if you sell it again, and it's add again, you have now what's called a wash sale, those things wash each other out.

So it sounds a little complicated. What I'm going to tell everybody what the audience should hear is 30 days, if you sell for loss, wait 30 days, buy it back on the 31st day, and give yourself 31-32 days. Other than that, don't hesitate to take losses or take gains. I'm sorry, apologize, and don’t hesitate take gains. Why? Well, short term gains, yep, they're going to be taxed at our ordinary income tax rate but long term gains held longer than 12 months, they're taxed at lower rates lower than our ordinary income tax rates. The tax law is somewhat favorable in these ways to us still. We have long term capital gains rates lower than our ordinary rates. We also have qualified dividend rates that are lower as well. So dividend paying stocks, you know, as long as it's called qualified, and a lot of stocks fall into that category. we were paying a lower tax rate on those so don't hesitate capture gains, don't look to miss don't look for strategies where you are losing money, because that's a you know, that's sort of against the strategy, if you will, but don't hesitate to take that loss 31 day rule, and remember, gains are taxed at lower rates.

Andrew 29:11

I hope you enjoyed the presentation. Once again, if any ideas came to mind or questions, please email at info@jgua.com and visit our website and follow us on social media for additional content. Thank you to all our listeners and until next time, stay smart.