[Programming your { **Financial Future** }()];

From stock options to tax planning, understand how to crack the code and make sense of it all

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The tech industry, especially on the West Coast, is changing the way professionals develop their careers and how companies structure compensation.

The competitive tech job market has led to a favorable climate for employees with companies offering attractive salaries and benefits. At the same time, the complexity of these compensation plans far exceeds what most are accustomed to – gone are the days of a single W-2 filing, a pension plan or a 401(k). This evolution means tech professionals face a much more involved, intricate task in setting the course for financial success.

Everyone has differing life events and preconceived ideas about money and how to manage it. Deciding how to allocate your money is a very personal decision. As advisors, our role is to equip you with the knowledge necessary to let you decide what makes the most sense for your personal situation.

Our experience working with tech industry clients has demonstrated time and again that those who plan or "write the code" for their future are more likely to benefit from their current situation and achieve financial independence. From tax planning to navigating how to best handle your company stock, our objective is to help you better understand your situation and the implications of your financial decision on your future.

Why Tech is **Different**

According to published reports, salaries for corporate tech positions represent the highest median salaries compared to other industries.[1] For example, starting salaries at Amazon average around $80,000 per year.[2] Employees can take advantage of their increased income and begin paying off student debt or maximizing contributions to their 401(k).

Competition between tech companies to hire the best talent has also led to desirable places to work with office perks and additional benefits, including company stock.

Depending on the success of the company, compensation in the form of equity can be a meaningful way to create lasting wealth. Long-term employees and senior executives can benefit from high salaries and additional stock-based compensation, resulting in a net worth of $5 million, $10 million, $25 million or more.

Higher salaries coupled with company equity differentiate tech professionals from many similarly aged adults in other industries. This combination, however, can lead to unexpected tax implications or missed investment opportunities.

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Building a Good **Foundation**

With any plan, you need to define your desired end result. What is it that you want to achieve? Is it financial stability, and the freedom to work less? Or maybe you want to travel more or spend more time with your family. We ask this question, among others, of all our clients.

Once you have defined your goal(s), the next step is to devise a way to get there - a financial roadmap, or plan.

We start by reviewing your current assets (e.g., investment accounts, employee stock plans, property) debts (e.g., student loans, mortgage, car payment/lease), and projected cash flow to estimate the amount of future assets you will need to meet your goal(s). We also consider your expenses and recurring withdrawals, including monthly expenditures. These expenditures include obvious expenses like mortgage, car loans, taxes and insurance, and also smaller one-off costs that can quickly add up such as travel, groceries, dining out, gym memberships, etc. This exercise helps us determine what your annual cash requirements are, an important component of your financial plan.

To fully understand your complete financial situation, we also review your current investment allocations and assess tax liabilities associated with your income or future estate plans. As your circumstances change, so does your financial plan, acting as a living document that continues to evolve as your life unfolds.

Below is an example of a balance sheet outlining a married couple's assets and liabilities.

Statement of **Net Worth**

	Spouse 1	Spouse 2	Joint	Total
Assets				
Investment Assets				
Joint Investment			$1,250,000	$1,250,000
RSUs		$600,000		$600,000
Vested RSUs	$75,000	$3,600,000		$3,675,000
Joint Bank			$75,000	$75,000
Total Investment Assets	**$75,000**	**$4,200,000**	**$1,325,000**	**$5,600,000**
Retirement Assets				
IRA	$44,000			$44,000
401k	$425,000	$350,000		$775,000
Total Retirement Assets	**$469,000**	**$350,000**		**$819,000**
Other Assets				
Primary Residence			$2,250,000	$2,250,000
Total Assets			**$3,575,000**	**$8,669,000**
Liabilities				
Mortgage			$650,000	$650,000
Total Liabilities			**$650,000**	**$650,000**
Net Worth	**$544,000**	**$4,550,000**	**$2,925,000**	**$8,019,000**

Despite our ability to plan for the factors within your control, there are various external factors that may be out of your control, so we test your plan in an effort to ensure that following your plan provides you with a high probability of achieving your financial goals.

// A financial plan is a comprehensive evaluation of an individual's current and future financial state using currently known variables in an effort to predict future cash flows, asset values and withdrawal plans. //

Understanding **RSUs, NQs** and **ISOs**

As an employee working in the tech industry, where compensation in the form of company equity is common, it is customary to have a large portion of your assets held in a concentrated position; you own shares of a stock that represents a large percentage of your investment portfolio. Therefore, it's important to have a basic understanding of how to best utilize your equity.

Most commonly, companies have structured their compensation approach to include Restricted Stock Units, Non-Qualified Stock Options, and occasionally Incentive Stock Options. All are a form of equity or interests in equity and offer different benefits for the employee.

Restricted Stock Units or RSUs follow a pre-determined vesting schedule set by your employer. These units typically have no actual value until vesting occurs. As your shares vest, you are automatically granted the units at the pre-determined date, which are assigned a fair market value (typically the current stock price). The value of these shares is generally considered ordinary income, meaning you will be taxed at your current income tax rate as the shares vest. A portion of your units typically are held to pay the income tax, and you receive the remaining shares. In rare circumstances, you may consider filing a 83(b) election at the grant date if you can ensure the value of the shares are going to increase over time. RSUs do not expire although any unvested shares will be forfeited if you leave the company.

Non-Qualified Stock Options or NQs differ from RSUs. NQs are priced at the fair market value when they are granted to you by the company, known as the grant date. The fair market value at the time of the grant is referred to as the strike price. As the options vest, you have the right to buy the stock at the strike price. Ideally, the stock price has increased since you were granted the options, meaning you are essentially buying the stock at a discount.

Once the options are exercised, taxes are typically owed based on the difference between the strike price and the current market price. NQs only have a limited term during which they may be exercised, after which they will expire. The

expiration date is set at the time the options are granted; commonly 10 years after the grant date. If you do not exercise your options prior to the expiration date, you forfeit the ability to exercise them in the future. If you decide to leave the company, the expiration date is typically reduced to 60 – 90 days.

Incentive Stock Options or ISOs are very similar to NQs. The most important difference is that ISOs may be subject to the Alternative Minimum Tax (AMT), which should consider when determining whether to exercise. The tax rules are complex, so we recommend discussing your options with a financial advisor or tax professional to ensure you avoid any potential adverse tax ramifications.

In each case, you may choose to keep your shares, but if you prefer to sell, the sale proceeds will be taxed just like the sale of any other security.

Considerations for **Concentrated Stock Positions**

Assuming you intend to keep your shares as they vest, it's important to consider what you want to do next. If you decide to keep your shares, you should understand the associated risks

The greater the amount of risk you are willing to take, the greater the potential reward. However, you also risk of significant loss. One way to evaluate the level of risk you are comfortable taking is evaluating how the outcomes may affect your current or future lifestyle.

In the example outlined below, you'll notice that when the share price of Amazon stock drops 40% in 2021, it directly decreases the value of your total assets. This chart shows **assumed market performance** by way of example. Bear in mind that there is no way to tell how the market will perform, but you can gauge your reaction to the market. When the market dips, your total assets are directly affected.

Holding	**Vested Shares**				
Amazon	250				
Year	**2020**	**2021**	**2022**	**2023**	**2024**
Amazon Share Price*	$ 1,977.59	$ 2,197.35	$ 1,318.41	$ 1,713.93	$ 1,371.15
Assumed Market Performance		10%	-40%	30%	-20%
Amazon Value	$ 499,397.50	$ 549,337.25	$ 329,602.35	$ 428,483.06	$ 342,786.44
Decline from Prior Year		$ 49,939.75	$ (169,795.15)	$ (70,914.44)	$ (156,611.06)

*April 6, 2020 close price

We recommend considering a few strategies as you evaluate how to optimize your shares for your personal situation and comfort level: keeping your shares, hedging your shares to reduce exposure and diversifying.

1. Keep Your Shares

As an employee, you know a lot about your company and may feel confident that your company's stock price will continue to rise, which benefits you directly. As long as you understand the associated risks and are comfortable with the potential downside, you may want to retain a large concentrated stock position.

Also consider how social pressures may contribute to your decision to keep your shares. You may feel loyal to the company or you may fear being left behind as your co-workers become wealthy. These types of emotional responses are common, but we recommend relying on your rational thinking and logic when making a financial decision, rather than emotion.

For example, it is typical for CEOs and other executives to sell a portion of their shares as soon as or right after the company's initial public offering (IPO). For example, Snap Inc. CEO and co-founder Evan Spiegel sold 16 million shares of the company's IPO in 2017, totaling $272 million.[3]

An executive's wealth or success is determined by a company that remains in his/her control internally, but the added weight of several external factors beyond his/her direct oversight presents a higher risk. Even though the executives may see large upside potential in the next quarter or year, there is the risk that the stock or share price may decrease in value. In this example, the decision to sell the shares has nothing to do with how the executive thinks the company will perform; rather, it is about locking in some amount of profit and mitigating the risk losing a significant amount of net worth.

2. Hedging Your Shares to Reduce Exposure

If you are looking to reduce exposure, but are concerned about missing out on upside growth, you may consider a hedging strategy. The benefit of using hedging options is that you can participate in some of the upside, while mitigating your loss potential should the price of the stock fall below a designated price.

Options consist of "calls" and "puts," which give you the right to either buy or sell shares at a specified price. To hedge a concentrated stock position, you can purchase a "put" on a publicly traded company, giving you the right to sell shares at a set price, even if the stock price goes much lower.

// Buying a put: gives you the right to sell shares at a specified lower price

Selling a call: gives someone else the right to buy the stock from you at a specified higher price //

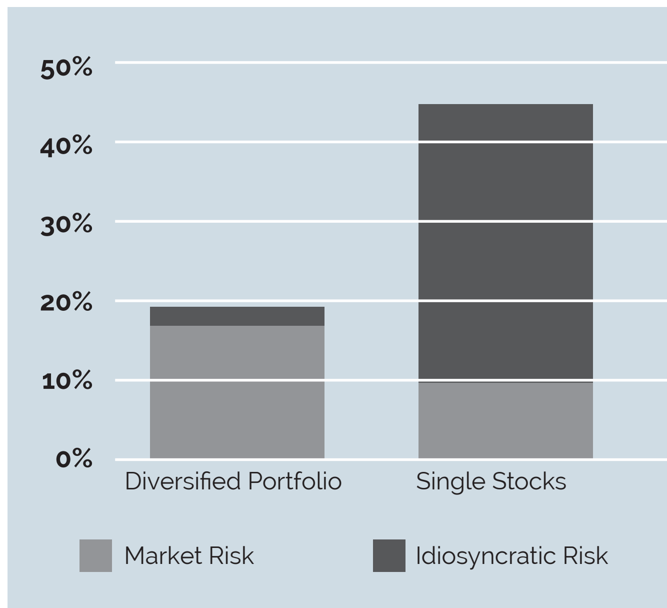
These options can be especially useful if you are comfortable with some downside, but your financial plan shows that your lifestyle would be greatly impacted if the share price were to drop below a certain level. Purchasing "puts" requires frequent renewal (typically every 12 to 18 months) and can be expensive. To cover the cost, you may consider a no-cost collar.

A no-cost collar strategy involves buying a put while also selling a call, so that the cost of the put is partially offset by the sale of the call.

3. Diversify

If you are inclined to sell, you can either retain the cash or reinvest the proceeds in other investments. If you decide to reinvest in the market, consider diversifying your portfolio. Below is an example of idiosyncratic risk (single stock risk) vs. market risk.

Average Annualized **Volatility**



Source: https://www.fidelity.com/viewpoints/investing-ideas/concentrated-portfolio

Volatility based on annualized standard deviations of weekly stock returns (past 52 weeks). Risk decomposition based on analysis of 52-week returns (annualized). Market risk measures the portion of volatility that can be explained by broad market moves, and idiosyncratic risk shows the portion of the volatility driven by individual stocks. Single-stock volatility based on the simple-average (equal-weighted) return of all stocks in the Russell 3000 Index. Diversified portfolio volatility based on returns of 5,000 simulated 150-stock equal weighted portfolios drawn randomly from the Russell 3000 Index annually. Source: FactSet, Fidelity Investments, data from January 1, 1995–December 31, 2014. Data as of June 30, 2015.

You can see that the volatility of the single stock position is much greater than a diversified portfolio. With a single stock, your risk range is much larger, meaning you could experience a larger upside but may also experience a greater downside.

A diversified portfolio has a greater market risk, meaning that you are tied to the overall performance of the financial markets rather than one single stock. You still experience a level of volatility, but it should be less than holding single stocks due to the breadth of the investments, including assets in different companies (i.e., stocks), industries, as well as different asset classes (e.g., bonds, commodities, real estate or private equity).

The underlying concept surrounding diversification is non-correlation.

Correlation:
1. **Mutual relation of two or more things, parts, etc.**
2. **Statistics: the degree to which two or more attributes or measurements on the same group of elements show a tendency to vary together**

One approach to diversification is purchasing investments that exhibit less correlation to your company shares or are even non-correlated. For example, when you sell a portion of your concentrated tech stock position in the tech industry you could reinvest in an industry or other asset classes that have very little correlation to tech. When two securities are non-correlated or less correlated, the two assets move independently of one another or less strongly in the same direction.

Investing in non-correlated or less correlated securities will allow your portfolio to respond differently to varying market conditions. You also lessen your exposure to the constant volatility of the market.

More Money, **More Tax Problems**

As your salary increases or you start to pay capital gains on your shares, it can be beneficial to consider ways to lower your income tax bill. We have several strategies that may make sense for you.

One common recommendation is to take advantage of the 401(k) options offered by your employer. A traditional 401(k) is an employer-sponsored retirement savings plan that allows you to invest a portion of your paycheck before taxes are taken out. Because your contributions are taken before tax, you effectively lower your taxable income for the year. Maximum contribution amounts change periodically and are currently set at $19,500 annually.

Let's look at how this might affect a single tax filer for 2020: Assume your salary is $180,000 and your marginal income tax rate is 32% (single filer). At the beginning of the year, you decide to contribute $800 per paycheck, or $1,600 a month, to your 401(k). By December, you would have contributed $19,200 on a pre-tax basis. According to the IRS, your salary is now $160,800, and you would have saved about $6,000 in taxes in the calendar year.

We also recommend checking to see whether your employer offers a health care flexible spending account (FSA) or dependent care FSA. If so, you may consider taking advantage of it.

An FSA is a pre-tax account that allows you to set aside money from your paycheck to pay for certain health care expenses. FSA contributions are limited to $2,750 per year per employee. Note that money allocated to the account will need to be spent within the plan year.

If you have children, you may inquire about the Dependent Care FSA – a pre-tax benefit account to pay for dependent care services such as preschool, summer camp, or after-school programs.

You may also be eligible to participate in a health savings account (HSA) if you have a high deductible healthcare plan. A high deductible healthcare plan is defined as one with a minimum deductible of $1,400 for a single person and $2,800 for a family (for 2020). An HSA can be sponsored by your employer, or you can open one on your own. In 2020, annual contributions are limited to $3,550 for an individual and $7,100 for a family. Contributions are made pre-tax, and funds can be withdrawn tax-free for qualified medical expenses. While the funds are held in the HSA, they will grow tax-free. An added benefit to HSAs is the ability to withdraw funds tax-free for any purpose – not only medical expenses – after age 65, making it another potential tax-advantaged retirement savings vehicle.

As a senior executive or high income employee, your employer may offer a Non-Qualified Deferred Compensation Plan, which would allow you to defer a portion of your compensation. To participate, you defer a portion of your income to an employer-sponsored investment account, deferring income taxes on that compensation until the deferred compensation is paid out.

Depending on your own unique situation, you may also benefit from other 'coding' issues related to your stock compensation such as 83(b) or 10b5-1 elections.

Considering Life's **What-Ifs**

Throughout this guide, we have suggested actionable ways to look at your overall financial picture; however, it's just as important to consider how to protect yourself from unforeseen and uncontrollable events. Insurance is one of the easiest investments you can make to protect yourself and your assets.

The most common types of insurance auto and home and you may already have policies in place. You should review those policies periodically, especially as your total net worth increases. It is common for us to review an insurance policy and uncover outdated policy limits that no longer fully protect you, our client, and/or your family.

One of the most common insurance options is automotive. You are likely already well-versed in collision, comprehensive and liability insurance, but do you know your coverage rates for bodily injury liability?

If you or any of your family members is involved in an accident that injures the other party, this coverage helps you pay for the other party's medical expenses and that party's lost income as a result of injuries suffered. These costs can quickly add up and once your minimums have been met, you are required to pay out of pocket.

If you own a home, you have homeowner's insurance. This form of insurance includes loss for diminished value or loss of use. This coverage is important to check regularly to ensure all your assets are covered so you can avoid any unexpected negative outcomes.

Certain circumstances may require you to consider excess liability or umbrella insurance. This type of insurance provides coverage above the limits of homeowner, automobile and watercraft policies. The coverage level should increase as your net worth grows and should cover the full value of your assets.

In **Conclusion**

By establishing a solid financial plan, and maximizing your insurance coverage, you can position yourself for short- and long-term success, while taking charge of your financial independence. From tax planning to navigating how to best handle your company stock, we hope this guide provides you with a better understanding of your situation and helps you "write the code" for your financial future. For additional information, please contact one of our Client Advisors at info@freestonecapital.com.

Freestone Capital Management is an employee-owned wealth management firm that simplifies the complexities of wealth so that our clients can focus on what matters most to them.

We work to understand our clients' goals to create a customized financial plan that addresses the entirety of their situation. Our investment approach is defined by our clients' objectives and may include a combination of traditional and alternative strategies, many of which are unique to Freestone.

Our experienced Client Advisors work alongside our clients, their attorneys, CPAs, and other trusted experts to ensure every aspect of their wealth and investment management is handled seamlessly, providing our clients with confidence and peace of mind.

Sources

[1] vox.com
[2] Payscale.com
[3] Marketwatch.com

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