Making Smart Stock Moves in a Down Market

By: Daniel Haut, CFP®, CIMA®

January 2023

Spotting the silver lining; Utilizing financial planning to lock in lower stock valuations during a bear market.

Arguably, 2022 will offer a future case-study that the old adage "buy low and sell high," is the most appropriate *long-term* investment strategy. Sure, "buying low" in 2022 may have felt more like getting proverbially kicked in the teeth. To add insult to injury, the "selling high" part of this aphorism wasn't exactly applicable last year as in previous years of tumult like 2020. As you may recall, in 2020, the pandemic bear market lasted all but one month (late February to late March). However, over the course of any long-term investment horizon, employing a disciplined strategy can enable investors to achieve this truism more often than not.

To be clear, "buying low and selling high," doesn't mean timing the *exact* top and bottom perfectly. If this was only so easy (I can feel reader's eyes rolling, sarcastically). Rather, over a multiple year time horizon, it is possible to purchase securities at relatively inexpensive intrinsic price points with a disciplined strategy. As I will discuss in this article, making smart moves in a down market can be easily done in retirement and employee executive compensation plans.

1. TAKE RMDS WITH STOCK VS. CASH

Paying taxes on IRA RMDs (Required Minimum Distributions) can be painful enough. However, paying taxes can feel doubly worse when doing so during a bear market. Further, if one has insufficient cash in their IRAs, selling distressed securities to raise cash for the RMD can lock in losses.

One strategy that many investors are unaware of is that they are able to take RMDs with stock instead of cash. During a down market, taking stock distribution as an RMD can serve many benefits.

First, you avoid locking in losses (e.g. selling stock during a poor market). Second, you can maintain your asset allocation (just in a different part of your portfolio). Third, you end up paying less tax per distributed share (e.g. same RMD divided by greater number of shares). Fourth, you lock in a greater number of shares for future market rebound at advantageous capital gains rates.

To illustrate the efficacy of this strategy, let's look at an example.

Jay McFagan is age 72 and is required to take out his $100,000 RMD by 12/31 of the current year from his $2,750,000 IRA.

Making Smart Stock Moves in a Down Market

Not only is Jay in the 37% tax bracket, but he has insufficient cash to take the RMD without selling securities. Doing so would lock in egregious market losses. While his IRA is diversified, he does have some concentrated employee stock in it as well. It just so happens that the employee stock is equivalent to the RMD amount. While the market is down 20%, his employee stock is down 30%.

For his pending RMD, Jay is trying to determine whether he should sell some of his securities to raise cash or distribute shares of distressed employee stock "in kind" to his outside living trust.

In order to demonstrate the potential benefits of this strategy, let's make a few simplifying assumptions. First, let's assume that Jay's life expectancy is age 95 (another 23 years). Second, the stock will produce an annualized 7% return until he passes away. Lastly, let's assume that Jay pays tax withholdings (federal/state) on his RMD with an outside account. To be clear, this strategy works best when taxes are paid from non-IRA assets.

Under scenario 1, Jay decides to leave the $100,000 of old employee stock in the 401k and sell other securities to raise cash for that year's RMD. At age 95, the $100,000 of employee stock not distributed (for that one year) is $474,000 based on a 7% annualized return. Since the stock is still in the 401k, the "after-tax" value, based on a 37% federal tax rate (don't include state taxes), is $298,653.

Under scenario 2, Jay decides to take $100,000 in distressed employee stock as his RMD. Again, based on a 7% annualized return, the employee stock is now worth $474,000 at age 95. Jay paid taxes on the initial RMD, so his cost basis is $100,000. Assuming a capital gains rate of 20%, his taxes are $74,800 ($374,000 gain x 20%) and his after-tax value is $399,200.

It is theoretically possible for Jay to achieve something similar by liquidating the cheap stock in his IRA (no tax consequences) and rebuying it at the low in his trust. Wouldn't this offer the same benefits you may ask? In theory, yes. However, operationally, it will take some time to process both the sale in the IRA and RMD transfer into Jay's trust. In the meantime, the stock could've skyrocketed in value, which means you'd be buying in at an otherwise higher price than simply transferring the stock in kind. Remember, during bouts of volatility, being out of the market for even a couple of days can translate into a 5-10% move.

As you can see, by taking distressed company stock as his RMD for that one year, Jay's after tax amount is ~$100,000 greater under scenario 2 due to tax arbitrage. Jay is freezing a greater number of shares (due to market drop) that will pay advantageous capital gains rates vs. ordinary income.

Making Smart Stock Moves in a Down Market

2. EXERCISE INCENTIVE STOCK OPTIONS (ISOS) UP TO AMT BREAKEVEN

For employees who are granted ISOs (Incentive Stock Options), timing when to exercise them can be fraught with complexity. Not only do these options have an expiration window (10 years), but exercising ISOs can inadvertently expose the owner to AMT (Alternative Minimum Tax) – more on this later.

Fortunately, when equity markets are down, exercising ISOs can be a way to turn lemons into lemonade.

The benefits of exercising ISOs in a bear market are two-fold. First, with a reduced price per share, the owner can exercise more shares in a down market before paying the dreaded AMT. Second, the owner can start the capital gains clock, which is important if one has concentrated stock with a goal of selling and diversifying. In order for capital gains rates to apply (on sale), ISOs require the owner to hold employee stock for 2 years from grant and one year from exercise. By accelerating the clock, the owner not only exercises more shares without triggering AMT, but they quicken the process of concentration risk reduction.

Before we get into a scenario, it is important to review some basic mechanics of ISOs.

Both ISOs and NSOs (Non-qualified Stock Options), have what's called the "bargain element" attached to them. The "bargain element" is the difference between the exercise price (the price at which a share can be purchased) and fair market value (FMV) of the stock. When options are "in the money," the strike price is at a discount to the FMV of the stock and the owner is compelled to purchase. However, based on the "bargain element," options (ISOs and NSOs) have different tax implications when the owner exercises them.

With ISOs, (unlike with NSOs), the owner does not owe ordinary income tax on the "bargain element." However, when calculating whether AMT is owed, the owner does have to add back the profit (e.g. bargain element). In fact, not only is the "bargain element" of the ISO added back, but a whole host of deductions like property taxes, mortgage interest, medical expenses, etc. are also added back. After an AMT exemption is applied, the FAMTI (Final Alternative Minimum Taxable Income) is taxed at 26% to 28%. The FAMTI is compared with taxable income and the difference is owed.[1]

<u>The point:</u> exercising too many ISOs can result in owing more money to the IRS in the form of AMT than one otherwise would. However, when stock prices drop, this serendipity allows owners of ISOs to take advantage of a higher "break-even AMT" threshold – exercising more options without paying the tax. Below is an example scenario.

Jocelynn Cheng is earning a $250,000 salary. She is married, files jointly, and uses a standard deduction for tax purposes (doesn't itemize). Let's also assume that Jocelynn's company grants her 5,000 shares of ISOs every

[1]*https://www.irs.gov/publications/p525#en_US_2021_publink1000229220*

year that vest at 25% per year. Jocelynn is worried about being overly concentrated in company stock and wants to diversify to reduce risk.

Jocelynn just became vested in 5,000 shares with a strike price of $20/share. In January of 2023, the market value of her company stock was $35/share and at a high. While she wants to exercise now, her CPA and financial advisor told her that doing so would result in AMT, in fact $12,355 worth. The "bargain element," of $75,000 ($35 - 20 x 5,000 shares) is added back to income. Despite applying the AMT exemption ($118,000), she would still owe over $12,000 when comparing to her taxable income.

Dejected, her CPA calculates that her "break-even AMT" threshold is $25,000 (vs. $75,000).

In June of the same year (six months later), the stock market drops by 30% (along with her company stock). The stock is now $25 (from $35/share). As it just so happens, her "break-even AMT" threshold happens to be $25/share and Jocelynn exercises all 5,000 vested ISOs!

Her "breakeven AMT" threshold is calculated as $25 - $20 x 5,000 shares, or $25,000. This amount is added back to income, and after AMT exemption applied (same $118,000), she owes $0 in AMT!

Additionally, she starts the long-term capital gains clock, and will be able to sell concentrated stock at advantageous capital gains rates when the market rebounds in one year.

3. MAX ESPP IN DOWN MARKET

In ESPP (Employee Stock Purchase Plans), participating employees defer a percentage of salary (up to $25,000/year) to buy company stock, often at a 15% discount. To be able to buy company stock at eighty-five cents on the dollar is enticing enough. However, during a downward market, both the *employee* and *market* discount can offer very cheap price points.

In short, during a down market, there are a couple of benefits to participating or increasing contributions to your company ESPP.

First, with a drop in stock price, you can purchase more ESPP shares per fixed dollar contribution. For example, if the ESPP allows a 15% discount, a simultaneous 15% drop in market price/share offers a 27.75% overall discount to the previous price!

Second, by buying employee stock when the market is down, one is *locking* in a lower ratio of ordinary income tax per share (relative to capital gains) at disposition. In ESPP plans, the "bargain element" (15% discount) is considered "compensation" and taxed as ordinary income upon sale. In essence, by buying ESPP stock at a low point, you're also freezing ordinary income tax per share (AKA "compensation/share"), at a low point.

Assuming an employee holds said shares for at least 2 years from grant and 1 year from exercise, any profit (difference between sales price and FMV at sale) is taxed at advantageous capital gains rates. This is akin to tax arbitrage.

Here's an illustration of the power of this strategy.

Aaron Von Millan is currently contributing 5% of his salary to his company ESPP plan. His company allows ESPP stock purchases at a 15% discount. The company stock is trading at a high of $20, and so he is able to purchase at $17 (85% x $20). Aaron's salary is $250,000 and his 5% ESPP contribution is $12,500. At the market high, he can purchase 735 shares ($12,500/$17).

Six months later, both negative earnings and a drop in the market results in company stock dropping 20% (from $20 to $16). Aaron's ESPP allows a "lookback provision" which enables a discount from the beginning of offering period or end of purchasing period, whichever is less. Since the stock is $16 per share by the end of each purchasing period, he can buy it at $13.60/share (85% x $16)!

To be clear, in certain markets, it may be beneficial to sell ESPP shares immediately. While it is a "disqualifying disposition," the short-term capital gains on an immediate sale would be negligible. However, in a down market, waiting the full 2 years from grant and 1 year after exercise is optimal if you don't want to lock in losses.

In short, the above illustration shows the benefits of ESPP contributions in a down market. First, by taking advantage of a 20% drop in price, along with his 15% ESPP discount, Aaron was able to purchase his company stock for 32% less than the high point ($13.6 vs. $20). With good fundamentals, this can translate into an excellent bargain. Second, with a reduced price, Aaron is locking in lower ordinary income tax per share. He can now purchase 919 shares vs. 735 shares, or 25% more shares per tax dollar (e.g. $12,500/$13.6)!

In summary, a down market, while unsettling, can provide opportunities for many investors who show fortitude, patience, and discipline. For investors who are RMD eligible and/or participating in employee compensation plans, market turmoil can provide a silver lining.

Before making any tax related transactions, please check with your CPA and Wealth Counselor.

The opinions expressed herein are strictly those of Osborne Partners Capital Management, LLC ("OPCM") as of the date of the material and is subject to change. None of the data presented herein constitutes a recommendation or solicitation to invest in any particular investment strategy and should not be relied upon in making an investment decision. There is no guarantee that the investment strategies presented herein will work under all market conditions and investors should evaluate their ability to invest for the long-term. Each investor should select asset classes for investment based on his/her own goals, time horizon and risk tolerance. The information contained in this report is for informational purposes only and should not be deemed investment advice. Although information has been obtained from and is based upon sources OPCM believes to be reliable, we do not guarantee its accuracy and the information may be incomplete or condensed. Past performance is not indicative of future results. Inherent in any investment is the possibility of loss.