Optimizing your equity compensation:
Five considerations for informed decision making

One of the rewards distinguished by corporate employment is equity compensation. Corporate employees accumulate company stock through a variety of compensation vehicles. Over time, as company tenure and career success build, wealth in the company's stock often becomes a significant share of one's assets. While such compensation is a passive wealth builder, concentrated ownership can present both opportunities and challenges.

De-mystifying equity rewards

Getting the maximum value from your equity compensation is the full intention of every executive. Along with the passive drumbeat of stock accumulation and the hectic pace of executive life, stock compensation often takes a back seat to other financial decisions in an executive's life and may be subject to hasty decision-making. Having a sound strategy for building value and extracting rewards is necessary to manage all the variables and the complexity of plan provisions. The economics of stock compensation can be de-mystified, quantified and evaluated in a logical way. The purpose of this white paper is to provide greater understanding about the types of compensation you may have, explore any restrictions around timing, reporting and decision-making for divestiture, and help you focus on what to do at critical points. We will delve into five considerations important to maximizing value and meeting your legal and regulatory requirements:

1. Planning
2. Timing
3. Tax Considerations
4. Risk Management
5. Compliance

Tax-mageddon

Higher taxes on dividends and capital gains are here. The long-term capital gains rate increased substantially starting in 2013, after the Bush tax cuts expired. It may be still appropriate to take advantage of lower long-term capital gains tax rates and sell certain assets, even if it means repurchasing similar assets. The suitability of this strategy depends on your tax rate, IRS tax policy, holding period and the impact of the Medicare surtax.

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Glossary of Equity Compensation

Stock options *offer the right to purchase a specified number of shares of stock at a specified price. The value of your options increases with the stock price. If the stock price falls below the specified price, you are not required to exercise, so you will neither gain nor lose value. The most common form of options used today are Nonqualified Stock Options ("NQSO"). Any gain from NQSOs is considered ordinary income. Less common option awards are Incentive Stock Options (ISOs). With proper planning, the ultimate difference between sale price and the ISO strike price may be treated as a capital gain*

Restricted stock awards *are tenured-based compensation, typically granted to director and above level employees. A restricted stock unit ("RSU") is a right to own stock after you have met any conditions imposed by the Company, often tied to tenure. A restricted stock award or grant provides essentially the same rights as the RSU; however, the shares are transferred to you at the time of award, subject to the condition that you would forfeit them if conditions were not met.*

Performance share units *are performance-based stock grants awarded to management. They vest contingent on meeting common performance targets. Vesting may be based on meeting such company goals as total shareholder return ("TSR"), earnings per share ("EPS"), sales, return on assets, return on equity, and levels of customer satisfaction. In some cases, the targets are based on company performance relative to its peers.*

A Stock appreciation right ("SAR") *offers a bonus equal to the appreciation in the company's stock, usually over a vesting period of several years. When the employee leaves the company, the company buys back the vested shares and unvested shares expire worthless.*

Employee stock purchase plans ("ESPP") *are employer-sponsored plans that allow eligible employees to periodically buy stock through payroll deduction, for which the company may provide a discount. The discount is treated as ordinary income at the time of sale.*

Defining equity compensation awards

Stock options, restricted stock awards or units, performance share units and stock appreciation rights are the most common forms of equity compensation. Many rank and file employees may participate in stock purchase plans, not typically for C-suite executives.

When it is time to sell, either for personal or valuation reasons, it may be daunting to "pull the trigger". Multiple plan documents, varying cost bases or strike prices and a host of tax and compliance issues must be considered. A review of the common forms of stock compensation may provide a useful starting point.

The importance of planning

Taking a thoughtful and strategic approach to your equity-based compensation can be rewarding and well worth your time and effort. Many executives leave money on the table when they base equity compensation decisions on short-term considerations or fail to consider economic, tax, timing and other variables. Careful and thorough consideration of these variables should guide you, along with personal and life goals for you and your family.

Other planning considerations include the level of concentration you have in company stock and options, your time horizon, risk profile and upcoming cash flow needs. In plans where an executive may have a choice among compensation types, his or her age, time horizon and risk tolerance may favor restricted stock over nonqualified, or the reverse. The longer your time horizon, the longer you can wait prior to taking action on your stock options. These operative considerations drive decision-making about your stock to achieve the best outcome and meet your financial planning requirements.

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Financial parity

Anything can happen in corporate life: merger, consolidation, reorganization or even company insolvency. Corporate employees who are prepared for various potential career outcomes benefit from having thought through their options, providing peace of mind in an uncertain world. Financial parity is the economic comparison of two or more alternatives. Financial analysis is the basis for determining financial parity at critical decision points.

For example, there may be four sunset scenarios in corporate life that an analysis of your stock compensation can address:

Planning for voluntary or involuntary termination			Considerations
Post-retirement	Voluntary	****Best	Retire on schedule with plan to meet goals.
	Involuntary	***Sub-optimal	May not be financially ready to retire.
Pre-retirement	Voluntary	**Good	Ready to change jobs or leave to pursue other interests.
	Involuntary	*Worst	Not ready to retire, having to dip into funds earmarked for retirement and other goals.

Financial parity is the economic comparison of two or more alternatives. Financial analysis is the basis for determining financial parity at critical decision points.

Financial parity in career decisions

The uncalculated value of unvested stock-based awards is often overlooked or undervalued in career decisions. An up-and-comer may fail to evaluate the financial parity between total compensation with a current employer compared with a cash compensation offer from a new one. Consider whether an offer can be stretched by a few months to vest the next option grant.

Timing

Timing is important in evaluating the grant and expiration dates of options, managing cash flow and meeting deadlines. There are deadlines for annual elections, reporting (i.e., 83(b) Election) – even for exercising vested options after you leave the company.

The timing of stock option exercise is very important to ISO holders. If you intend to qualify for capital gains treatment, you should exercise and hold for a year and a day.

Stock options

Incentive Stock Options (ISOs) and Nonqualified Options (NQSOs) appear to be quite similar. The difference is in tax treatment, as we will cover in more detail under Taxation on page 5. Importantly, for an identical amount in economic profit, ISOs offer the opportunity to pay significantly less in taxes for those who meet the standards to qualify for long-term capital gains treatment.

The timing of stock option exercise is very important to ISO holders. If you intend to qualify for capital gains treatment, you should exercise and hold for a year and a day. Taxes on the transaction will be due on April 15 of the following year. Exercise early in the year to optimize cash flow and have sale proceeds available early the following year to meet your April tax obligation. The exercise and hold timing benefit should not be overlooked (See example on page 7).

Holders of both types of stock option awards should be mindful of their vested options at the time of separation from the company. Under common provisions, you must act on vested options within the 90-day window following termination, at which point vested option grants will expire unless they have been exercised. Most stock incentive plans afford greater leniency for disability and death.

Nonqualified deferred compensation

The two advance timing issues for non-qualified deferred compensation involve the annual election and the ultimate distribution of benefits. Each year, the company offers participants the chance to designate their contributions for either lump sum or installment payments upon distribution, up to the company's deadline. Missing the deadline means the company may automatically override your preference this year.

When it comes to the timing of distributions, pre-planning allows you to plan your withdrawal when you expect to be in a lower tax bracket. The difference in tax liability could be quite significant, particularly if you receive your nonqualified plan distribution in a lump sum payment.

Multiple tax considerations

As you know, the rules and taxation for different types of compensation vary, as well as your cost bases. While taxes are an important consideration, when making decisions about your stock transactions, be sure to give equal weight to investment and tax considerations. Here are a few considerations.

One of the most common mistakes is paying taxes on option gains at ordinary income rates upwards of 39.6%, instead of at the capital gains rate of 20%, or possibly lower at 15%. If you are in the highest ordinary tax-bracket, don't forget the new 3.8% Medicare Net Investment Income Tax that could result in a total of 18.8%/23.8%.

Tax Considerations

Many executives leave money on the table by exercising their options without considering the most tax-efficient ways to divest. One of the most common mistakes is paying taxes on option gains at ordinary income rates upwards of 39.6%, instead of at the lower capital gains rate of 20%. Holders of ISOs may qualify to pay significantly less tax than NQSO holders. The following two examples for XYZ Corporation compare the tax treatment of ISOs vs. NQSOs for an executive who received vested grants of each at $10/share dated 1/1/10:

Example #1 – ISO option granted 1/1/10 in XYZ at $10/share (exercise price)

XYZ Option at $10	Your action	Taxable event	Pay tax on...	Tax type
Jan. 13, 2013	Exercise $10 option and hold at $20, prevailing market price	No ordinary income tax at exercise	No tax at exercise, except possible AMT	AMT
Jan. 14, 2014	Sell at $30	Capital gains tax of 20% payable 4/15/15; credit AMT	Sale price less option price = $20	Capital gains rate of 20%
		No ordinary income tax at sale	Tax due on 1,000 shares with $20/ share gain	$4,000
Tax bill		N/A	$4,000 at sale	Total $4,000

Example #2 – NQS option granted 1/1/10 in XYZ at $10/share (exercise price)

If an executive wants to participate in the growth of the company but faces option expiration, here is a way to do that:

XYZ Option at $10	Your action	Taxable event	Pay tax on...	Tax type
Jan. 13, 2013	Exercise $10 option and hold (prevailing market price is $20)	Report value of $10/share at exercise	$10/share at ordinary income level	Ordinary income rate of 39.6%
Jan. 14, 2014	Sell at $30	Capital gains tax payable 4/15/15	The difference between sale price less price on date of exercise = $10	Capital gains rate at 20%
		Tax due on 1,000 shares at exercise ($20 - $10 at 39.6%)	Taxes due on 1,000 shares ($30-$20) gain following sale 20%	
Tax bill		$3,960 at exercise	$2,000 at sale	Total $5,960

Impact of Alternative Minimum Tax (AMT)

Be mindful that your stock transactions may trigger the AMT; particularly if your AGI is between approximately $150,000 to $650,000.

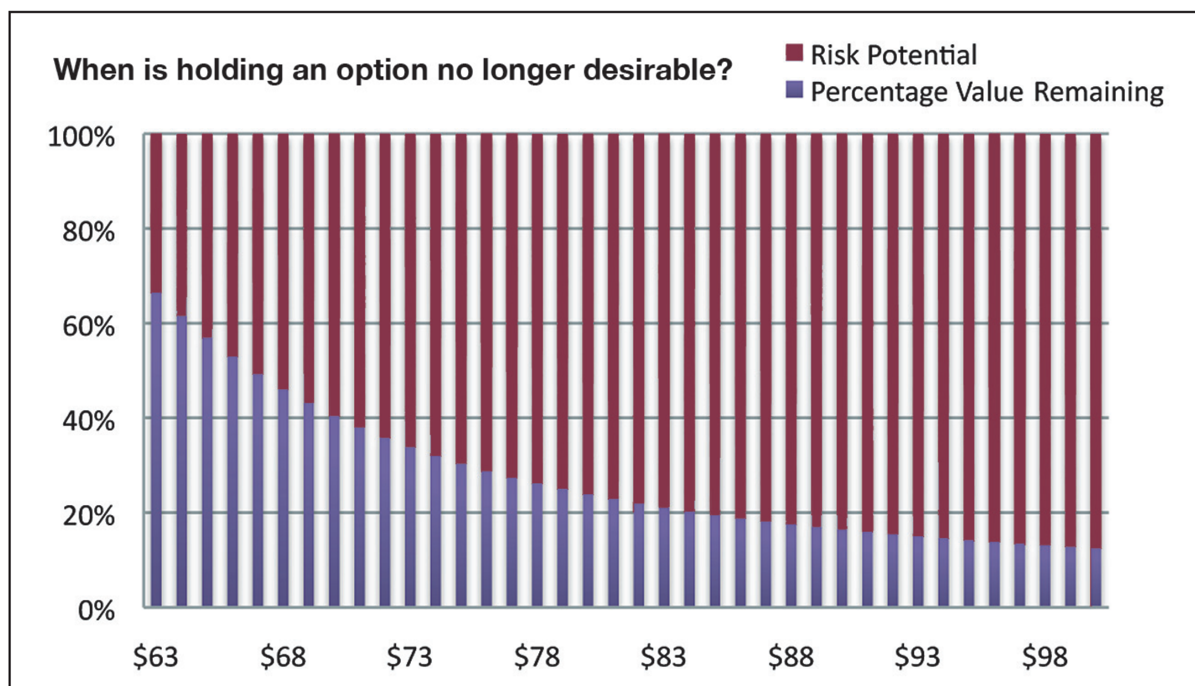
IRS Section 83(b) election

Executives can get favorable capital gains treatment by stepping up to pay ordinary income tax on stock options or restricted stock within 30 days of the award, as long as the stock is held for one year and a day past the election. This is known as an 83(b) election, after the relevant section of the IRS code.

Risk Management

The decision to reduce risk by selling at a certain price level is an essential part of optimizing your rewards. Setting price targets based on an analytical framework helps to minimize the emotion and subjectivity and lets market price and optimization drive divestiture. Many executives find it difficult to sell optimally; they are either too busy or too personally involved in the company to recognize when it is time to sell. In the absence of a price target, they sell when they have time, need liquidity or at the end of the year. These may or may not be the best times to sell; however, they do not provide a sound basis for good selling discipline.

Stock options can be evaluated based on the Black Scholes model, the most widely used method, to determine the time value of stock options. The Black-Scholes model is a Nobel Prize-winning formula that can price the theoretical value of an option on the basis of a series of variables. This analysis reveals how the time value of stock options diminishes over time, so that if the price target is reached, it will be a trigger for divesting. The chart below demonstrates how the percentage of value remaining diminishes as the stock reaches full theoretical value:



We rely on the StockOpter® model (Net Worth Strategies, Inc.) to estimate the level of risk potential for every increment of remaining value. The model is based on the historic standard deviation expected volatility of the stock, the in-the-money value, and the current stock price. In this example, the model tells us that, when the stock is trading at $83, the option holder has captured nearly 80% of the value, and there is substantial downside potential in waiting to capture the remaining value. While the construct of the valuation is complex, the take-away is simple: at a certain price level, it is time to exercise when the upside capture is less likely than the downside risk.

Compliance

Compliance with regulations and company policies has never been more important. The Dodd-Frank Wall Street Reform and Consumer Protection Act had a profound impact on corporate governance and executive compensation practices. Say-on-Pay rules gave shareholders the right to weigh in on Executive Compensation to a greater extent than ever before. Equity compensation has become more visible, and while shareholders and board members encourage this type of ownership, the investing public is watching.

Corporate insiders — officers, directors, and employees — must report their trades when they buy and sell stock in their own companies.

Insiders and principals

You will find the company and its corporate counsel are compelled in oversight of their executives' stock sales due to their own obligations. They may also assist you in meeting yours. Corporate insiders—officers, directors, and employees— must report their trades when they buy and sell stock in their own companies. You are required to file Form 4 with the SEC within two days of purchase or sale of company stock. Under the Securities Exchange Act of 1934, two sections impact the stock sales of insiders and the regulatory filing responsibilities that must be met by directors, officers and principal stockholders. Section 16 also affects each beneficial owner of more than 10% of the company, or any director or officer of the issuer. Section 14 affects any Named Executive Officer who is privy to insider information.

Pre-planned sale transactions

Many senior executives favor systematic divesting for planned sales within prescribed timing and volume guidelines. Under SEC Rule 10b5, an executive may prepare a binding written and defined 10b5-1 plan that specifies one's pre-planned sale transactions. The document must state the number of shares to be bought or sold, prices at which the shares will be bought or sold and the timing of the purchases or sales. The plan must be set up six months prior to the first transaction and must be created only when the executive is not in possession of material nonpublic information. Executives who hold more than 10% of the company's shares are subject to additional considerations.

Here is an example of a 10b5-1 plan instruction agreed to in writing between an executive and her investment firm:

"Sell 10,000 shares on the first trading day of each month. If the stock price has increased by 5% since the prior sale date, then sell 20,000 shares, instead of 10,000 shares."

Rule 10b5-1 trading plans provide an affirmative defense (but not a shield) to allegations of insider trading.

Summary

The complexity around stock-based compensation can be daunting, given the demands on an executive's time as well as work and family schedule. You understand the significance of having so much of your wealth tied up in company stock, as few in your company realize. In order to gain control over your finances, a sound strategy around your equity-based compensation is needed to make rational economic decisions. It is important to have a skilled partner and executive financial coach who is knowledgeable about the plan design, taxation and accounting, and who can wade through plan documents and make recommendations. Peace of mind is at hand.

SFG's Mission: ***Navigating toward financial peace of mind***

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Georgetown Crossing, Suite 140
3655 U.S. Route 202
Doylestown, PA 18902

(215) 345-5601
WWW.SFGADVISORS.COM