The Great Drawdown: How to Optimize Stock-Based Compensation for Planned or Unplanned Retirement

Retirement is the long-awaited culminating event of a corporate career. Over a lifetime, a corporate career is dotted with milestones, promotions and assignments in distant cities. The executive contributes to team triumphs and experiences solo setbacks. The drive and energy required is relentless and exhilarating. The closer an executive rises to the top, the harder it is to stay there. At some point, whether the timing is right, health and wellness issues intervene or there is something more compelling to do than continuing the pace on the corporate treadmill, retirement becomes the next step.

Bridging the Gap

The financial considerations of retirement take in a variety of topics: the sufficiency of assets; the individual's retirement age; the mix and age of corporate benefit plans; and the individual's lifestyle and income requirements. When retirement is planned for age 55-65, there is often an expectation that savings will bridge the income gap until the qualifying age to receive pensions and Social Security. During that period, other funds can bridge the gap. The gap can be bridged from savings as well as the value from the concentration in stock-based compensation – stock held in a variety of accounts and plans.

When retirement is unplanned, the executive may need to rework the plan to cover a broader than intended gap between now and the qualifying age to receive pensions and Social Security. The complexity surrounding stock-based compensation clouds the dilemma: Which funds should be drawn from to optimize the performance and minimize the tax consequences? This paper is designed to assist in briefing the reader on how we go about sequencing cash flows to cover living expenses in retirement.

As retirement approaches, the challenge of constructing a reliable cash flow to meet retirement expenses comes into view.

Planned vs. Unplanned Retirement

A carefully constructed retirement timeline can go awry when overtaken by events from job insecurity to a health issue or a combination of factors.

> *Keith, 57, qualified for retirement two years ago, after 25 years with the company. Since the birth of his third grandchild, his wife Penny has wanted them to move closer to Savannah to spend time with their daughter and her family. Keith will qualify for a generous pension at 62. At 66 and 4 months, Social Security, although not substantial, will be an additional income source. He's on board with the notion of retiring, but how can he cover the gap between now and his pension-eligibility age?*

The closer to retirement you are, the more you are thinking about how all of your assets can be deployed to meet a monthly expense budget. Fortunately, many corporate executives find their income needs will be sufficient once they tap their pension; the real question is, what is the optimal way to meet the gap?

Personal income statement

How much income will be needed to sustain your lifestyle in retirement? Some executives are detail oriented about tracking expenses and budgeting cash flow needs; others tend to look at their finances over a longer period of time. At this point, you may realize you need a clear understanding of your targeted expenses in order to match them with income. This is done through a spending plan, based on what your household needs are expected to be and what they have been historically. Typically, we recommend a rule-of-thumb spending target of two-thirds or three-quarters of pre-retirement spending as the amount to budget for. Based on your age and the number of years before you can tap into pension and Social Security, we have quantified the retirement gap.

There are many ways to track expenses, including programs like Quicken or budget tools we use. By gathering bank statements, spreadsheets or other budgeting software reports, we can provide a template to help you quantify your expense picture. As you enter a new phase of life, this could be a good time to begin using an electronic template, unless you use one already, to track your spending and benchmark your actual income and expenses.

We provide access to a digital wealth management portal through our budget tools, which helps users keep track of what they spend, access their balance sheet and view their investment accounts. You can also interact with your advisor in real time to guide decision-making. When it comes to cash flow, our tools provide easy expense tracking to help you on an ongoing basis.

Spending Analysis

Are you aware of how much you spend and what kind of income you need to meet expenses? The first step is to pull together an estimate of your current household expenses. We usually target an amount of 2/3 of pre-retirement expenses as a reasonable spending budget in retirement. That's because certain expenses – commuting, restaurants, wardrobe, and parking – often decrease once you retire.

Will you be carrying any debt? It may provide peace of mind to pay off loans and mortgages before your retirement date. The financial implications of carrying a mortgage into retirement may be secondary to knowing you are free and clear and without indebtedness. People with ample assets often like to pay off their mortgage and start retirement with clean slate. It's often a matter of peace of mind more than a significant financial consideration. Time to sharpen your pencil and do the calculations.

Living expenses in retirement are lower than pre-retirement costs for many people; at the same time, a new lifestyle may trigger increases in certain expenses. One school of financial planning estimates a declining expense picture over time, starting with the years when you first retire -- the "go-go" years -- to the "slow-go" years when you spend less on travel and adventure; to the "no-go" years in your 90s, if you are among those who live that long. Here are the key areas of the retirement budget:

Top areas for retirement expenditures:

1. Housing
2. Health care
3. Taxes
4. Transportation
5. Travel
6. Caring for kids and grandchildren

As financial planners, we can assist you in developing a spending plan and quantifying the top categories of your spending. Whether you use Quicken or can gather your bank statements, we can provide a template for spending categories and provide access to budget tools to track these expenditures on an ongoing basis.

After you have quantified your spending needs, we can help you determine the best way to create income to meet your spending needs.

Rules of Thumb in Accessing Income from Savings and Retirement Assets

Best and Worst Sources of Funds: Taxes Matter

Rules of thumb for accessing income for retirement:

1. Withdraw already-taxed assets first;
2. Live off lowest earning assets first; then higher earning ones.
3. Assets whose sales are subject to capital gains first; that will cost less in taxes than assets subject to ordinary income taxes.
4. Live off taxable accounts first vs. tax-exempt assets. Funds you withdraw from most retirement accounts will be taxed as ordinary income and should be tapped last, unless required by RMD.

In the hierarchy of assets to draw from, it is best to withdraw the "already taxed" assets before pre-tax assets such as retirement plans. As you are aware, any funds withdrawn from pre-tax retirement accounts, such as 401(k), would be taxed at ordinary income rates, and could even involve penalties if withdrawn prior to age 59-1/2; consequently, these assets should stay in tax-deferred vehicles as long as possible and should be the last to be tapped voluntarily. Of course, at age 70-1/2, you will be required to withdraw a mandatory percentage of these assets in the form of required minimum distributions ("RMDs").

The accounts that have already been taxed, and may not be earning much, include bank accounts earning ½ -1%; funds invested in assets subject to capital gains tax; followed by those accounts where a sale will trigger ordinary income tax, such as certain forms of stock-based compensation.

There are several variables to assess when constructing a retirement income plan. The assets on which you have already paid taxes should be redirected to remain tax deferred for as long as possible. Taxes have a profound impact on your net income; therefore, we conduct modeling to impact tax liability under different scenarios. For example, the tax impact of selling the mountain home this year or next year can be quite significant, and must be coordinated with the timing of other financial events.

These guidelines are considerations for constructing the income stream to cover retirement expenses. In many cases, you can optimize your tax situation by paying close attention to the differences in assets that look similar but are vastly different from a tax perspective.

Analysis of Stock-Based Compensation

Company stock is a perfect example of assets that look similar but are handled quite differently, depending on the type of compensation, the type of account in which they're held, and the timing. After accumulating stock in various forms of stock-based compensation, many executives hold an "alphabet soup" of different kinds of compensation: ISOs, NQOs, Restricted Stock, Performance Awards, RSUs, PSUs, SARs and Phantom Stock. Are you aware of the economic, tax and qualitative factors that enter into their use? Each is subject to different vesting schedules, different timing and tax implications.

Stock Options – ISOs and Nonqualified Stock Options

The rules regarding the taxation of stock options can be complex and it's all too easy to conflate the two types. The most common form of options used today are **Nonqualified Stock Options ("NQOs")**. Any gain from NQOs 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.

With respect to ISOs, the treatment of disqualifying dispositions and the impact of ISOs on the alternative minimum tax are especially complex. For NQOs, the tax treatment is relatively straightforward.

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 ISO 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 NQOs holders.

Restricted Stock

A restricted stock award is a grant of company stock in which the rights are restricted until the shares are fully vested. The stock is taxed at vesting, which makes restricted stock a favorable source of funds to bridge the retirement gap.

In certain situations, it may be appropriate to consider making a section 83(b) election. An 83(b) election notifies the IRS you'd like to accelerate payment of ordinary income taxes at grant date and not vesting date. The election is appropriate only for stock that is subject to vesting, since grants of fully vested stock will be taxed at the time of the grant.

Performance Shares

Performance shares are performance-based awards that vest contingent on meeting common performance targets, such 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. Because they are taxable when they vest, performance shares are a good source of income at retirement. One caveat: many companies have instituted a post-vesting holding period on performance shares. Performance shares that may vest soon, could be subject to a two-year post-vesting holding period. If they are, this means the funds would be unavailable to you until you're able to sell these vested shares two more years after the vesting date.

RSUs and PSUs

A **Restricted Stock Unit ("RSU")** is a grant in terms of company shares; however, the value of the shares is released to the executive only when it vests, which is often tied to tenure. **Performance Share Units ("PSU")** are performance-based stock grants awarded to management. Both RSUs AND PSUs are good sources of income at retirement, because they've been taxed already.

Stock Appreciation Rights and Phantom Stock

Stock Appreciation Rights ("SAR") offer a bonus equal to the appreciation in the company's stock, usually over a vesting period of several years. Phantom Stock is a promise to pay a bonus equal to the value of a company's stock or an increase in value of the stock over a fixed period of time. These two forms of compensation are similar. As with Phantom Stock, the SAR is normally paid out in cash, but it could be paid in shares.

Other Company Stock

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.

Company Stock Drawdowns

Given the complexity of tax treatment and the variables distinct to each compensation type, the relevant criteria we follow in evaluating each compensation type for source of funds includes:

Economic – there are economic considerations unique to each form of compensation. In the case of options, for example, we want to consider when the fair value of an option has been realized. What would you need to earn somewhere else to equal holding on to the option?

Tax – equity compensation that has already been taxed can be sold with the least tax impact. As an example, it may make sense to liquidate your PSUs, since ordinary income taxes were withheld when they vested.

Qualitative factors – are there other reasons to hold company stock, such as optics, dividend income or other rationale? To meet any trading concerns, we may recommend a written plan for divestiture of company securities.

10b5-1 Trading Plans

Planned trading programs, also known as rule 10b5-1 trading plans, can be put in place to facilitate systematic sales. This can be an affirmative defense against insider trading risks. The planned sales are scheduled in advance, designed for predictable cash flow to meet your income goals, while helping you to avoid interruptions such as blackout periods. These plans are established within a "safe harbor" by the Securities and Exchange Commission to allow for a predetermined trading plan that allows you to trade company shares, including stock options, while avoiding insider-trading liability.

We take into account that each executive is balancing a different set of variables. There are certain considerations distinct to each type of compensation that may make it more or less appropriate to tap before other forms of compensation. This white paper is based on our experience; however, it is the plan document and not the guidance provided here that will ultimately determine the vesting schedule, tax treatment and our ultimate recommendations based on your stock-based compensation.

Now that we have covered stock-based compensation, we continue to help you scrutinize and evaluate other income sources you may have considered. Many executives have been approached with a sales presentation for annuities. It is our considered view that annuitization is not optimal for most people.

Annuities: Why Give Up Control of Your Assets?

Many people are attracted to the story they are told about annuities. In simple form, you would take a sum of cash and invest it to produce a monthly stream of income for a fixed period or for life. What's left unsaid is that you relinquish control of your assets in order to receive a "guarantee" of income.

Annuities are among the most expensive investment types, because there is a charge for the insurance and another cost for the underlying investment. In addition to being very expensive, annuitization ties up your funds so they are not yours to redeploy should you decide to use those funds for another investment or purpose.

Annuities are said to be "guaranteed" by the issuer, a claim that is loosely regulated. History has shown the guarantee to be less than absolute as shown by two high-profile examples. When Baldwin United (1983) and Executive Life (1991) entered bankruptcy, they eventually settled with the annuitants for cents on the dollar. For this reason, it's important to understand how you are protected in your state, should the insurance company offering the annuity go out of business.

If you benefit from a pension or social security for the vast majority of your retirement years, you don't need to tie up long-term funds in an annuity. Maintaining control of your own assets in a long-term investment plan is, in our view, a more prudent retirement income strategy.

Social Security and Health Care

One reason Social Security is part of every retirement income strategy is because it offers several components that serve a retiree over time:

1. It is a monthly income stream that is guaranteed, often in contrast to other streams used to fund retirement expenses;
2. Social Security is subject to cost-of-living ("COLA") increases that help to keep pace with inflation and
3. Social Security payments are designed to continue throughout the life of the insured.

Lifetime Value of Social Security – Wait Until 70 or Begin Drawing When Eligible?

Every retiring executive needs a strategy for collecting Social Security, which has been called an insurance policy against a long life. Your health and life expectancy can play a big role in your Social Security strategy. In order to maximize the payment it may be useful to examine the lifetime value of Social Security. For those who don't need it or plan to continue to work in retirement, it may make sense to defer, thus allowing you to lock into a higher benefit amount up to the ceiling at age 70, the maximum age at which you should begin receiving the benefit.

Those who expect to live past 82 (the breakeven point between collecting lower Social Security amounts at 65 or deferring until age 70 maximum) may benefit from deferring to age 70 to maximize their benefit. By examining the projections for both spouses, it is possible to maximize income over time.

Depending on your income, you can expect your Social Security income to be subject to Federal income taxes. For example:

If you file a joint return, and you and your spouse have a combined income* that is more than $44,000, up to 85 percent of your benefits may be taxable.

In many states where our clients reside, including Pennsylvania, Ohio, New Jersey, New York, Delaware, Maryland, Virginia and more, Social Security is exempted from state and local taxes. Check with www.taxfoundation.org for state tax policy affecting Social Security if you live in a state not mentioned here.

Pensions

Fewer companies than ever offer defined benefit plans in this age of people living longer in retirement. Longevity risk – the risk of outliving one's assets – has been transferred to their employees in the form of defined contribution plans, mostly 401(k)s. Those who are lucky enough to have earned a pension have decisions to make to ensure you follow a pension maximization strategy. You will be offered the chance to compare the short- and long- term implications of your pension elections. A retired couple has two lives to cover; therefore, the option offering the greatest joint-and-survivor benefit is likely the best option.

Joint-and-Survivor Benefit

Jeff is age 57, and plans to choose for the pension maximum cash benefit of $8,000 per month. When he dies, his wife Marge would receive $0 remainder benefit.

Or, he can choose a monthly benefit of $6,500 per month covering joint and survivor. This means after dies, his wife Marge would receive 100% of his benefit.

If he chooses the latter, he has made a life insurance decision that will cost him $1,500 a month in opportunity cost ($8,000-6,500 per month in order to cover income for the remainder of his wife's life).

Or, he can pair the higher pension amount ($8,000) with a private insurance policy offering a monthly benefit to his wife of $8,000 per month in the event of his death. This would make sense if the premium costs less than the $1,500 per month. If the non-working spouse dies first -- in this case, Marge – he could cancel the policy and free up the premium amount. This strategy also provides additional remaining assets to heirs, whereas the joint and survivor pension would stop upon the 2nd person's death.

We work together to find the right solution to benefit both spouses in a cost-effective way.

Summary

When it comes to managing our clients' stock-based compensation, we apply specialized insight with concentrated stock positions that are subject to complex tax and regulatory considerations. The process we follow to meet income needs in retirement incorporates compensation, tax, income and estate planning needs and includes the following steps:

1. Plot the resources/expenses for each year to determine the quality of income stream for five or more years;
2. Integrate the timing of funds available, taking into account when vested shares clear the post-vesting period;
3. Plan to access on date certain, the retired executive's 401(k) and IRA accounts, as well as Social Security, in the future;
4. Maximize the lifetime considerations for use of retirement plan accounts, Social Security and IRAs;
5. Combine these variables in an income-source matrix that will provide the roadmap for the specified goal.

Having a well-conceived financial plan will ensure that the executive has a firm grip on the controls and prepares for the future with confidence.

About SFG Wealth Planning Services, Inc.

SFG Wealth Planning Services, Inc., based in Philadelphia, is a national financial planning service for corporate executives. Founder Charles "Chuck" Steege, CFP®, CEP, is a Financial Advisor to senior leaders of public companies. He helps executives unlock the value from their varied and complex equity awards by combining his experience as a financial planner and equity plan professional. Advisory services are offered through SFG Investment Advisors, Inc., a Registered Investment Adviser. The information provided herein is based on current tax law, which is subject to change at any time.

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