Equity Compensation

A topical review of equity based compensation and the planning issues to consider when receiving this form of corporate benefit

Executive Consulting of Raymond James

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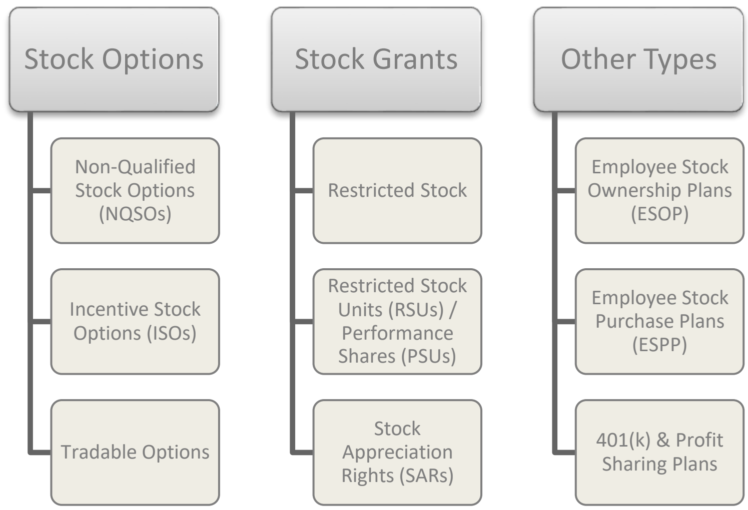
A common way to reward executives for performance is by providing additional benefits, beyond a cash salary and bonuses, with awards tied to the company's stock price, otherwise known as "Equity Compensation."

For the company, equity compensation provides a direct link aligning the executive's performance with the company's stock performance. This motivates employees to focus on the issue that matters most to shareholders – fundamental performance that increases the market price of the company's stock.

For the employee, equity compensation provides additional value for performance that can grow with the company's success. However, it also comes with tax and planning considerations that should be understood.

Equity compensation can come in many forms including stock options, restricted stock, RSUs and SARs. Each company has an approved compensation plan that should be reviewed upon the receipt of new awards.

COMMON TYPES OF EQUITY COMPENSATION



PLANNING CONSIDERATIONS

- When is the best time to exercise stock options?
- Which option grant is the best to exercise?
- What are the tax ramifications of each type of grant?
- What strategies are available to minimize potential exposure to Alternative Minimum Tax?
- What is the best method to fund the various exercise and tax costs?
- When is an 83(b) election appropriate?
- What factors should be considered when offered a choice of various equity compensation packages?
- How does risk tolerance fit into equity compensation decisions?

As federal and state tax rules are subject to frequent changes, you should consult with a qualified tax advisor prior to making any investment decision.

Stock Options

There are two types of stock option grants: incentive stock options (ISOs) and non-qualified stock options (NQSOs). While the two styles of options share common terminology, the tax and planning considerations differ widely.

All option contracts have the same basic variables.

- Grant date: the date on which the option is awarded to the employee
- Vesting date: the date on which the option grant becomes exercisable by the employee
- Expiration date: the date on which the option grant is no longer valid
- Underlying shares: the number of shares that can be acquired through exercise of the option
- Strike price: the price that must be paid to exercise the option and acquire the underlying shares, most commonly the stock's market price at the time of grant
- Exercise: the act of making use of the right afforded by an option grant that requires the delivery of cash in exchange for shares

When receiving an option grant from an employer, the executive will receive a notification that defines the above variables for their specific award. The company should also provide access to the approved company benefit plan that explains additional details of the award.

Incentive Stock Options

ISOs, sometimes referred to as qualified stock options, provide favorable tax treatment to the option holder as long as certain requirements are met.

Under the regular tax system, long-term capital gain tax is assessed only when the underlying stock is ultimately sold if the requirements set forth in Internal Revenue Code Section 422 are satisfied.

In other words, no tax is assessed when an ISO is granted and, under the regular tax system, no tax is assessed when an ISO is exercised. However, when an ISO is exercised the option holder may be subjected to the alternative minimum tax (AMT).

The value between the strike price and the fair market value on the date of exercise is considered an AMT preference item and is added to the option holder's income for the purpose of calculating AMT. A tax professional should be consulted to discuss the potential impact of AMT.

When the underlying stock is ultimately sold, the value between the strike price and the sale price is taxable to the option holder as long term capital gains. As mentioned earlier, the favorable long-term capital gains rate will only apply if the requirements of Internal Revenue Code Section 422 are satisfied.

A summary of the exercising and subsequent holding requirements of IRC Section 422 that pertain to the option holder is as follows:

- The option must be exercised within 10 years of the grant date.
- Only the individual who is granted the ISO may exercise it. An ISO may be transferred only at death to the optionee's estate or beneficiaries.
- The maximum total value of stock (determined as of the grant date) that is exercisable during any one calendar year is $100,000.
- The stock acquired through the exercise must be held for at least two years from the grant date and one year from the time it is exercised.

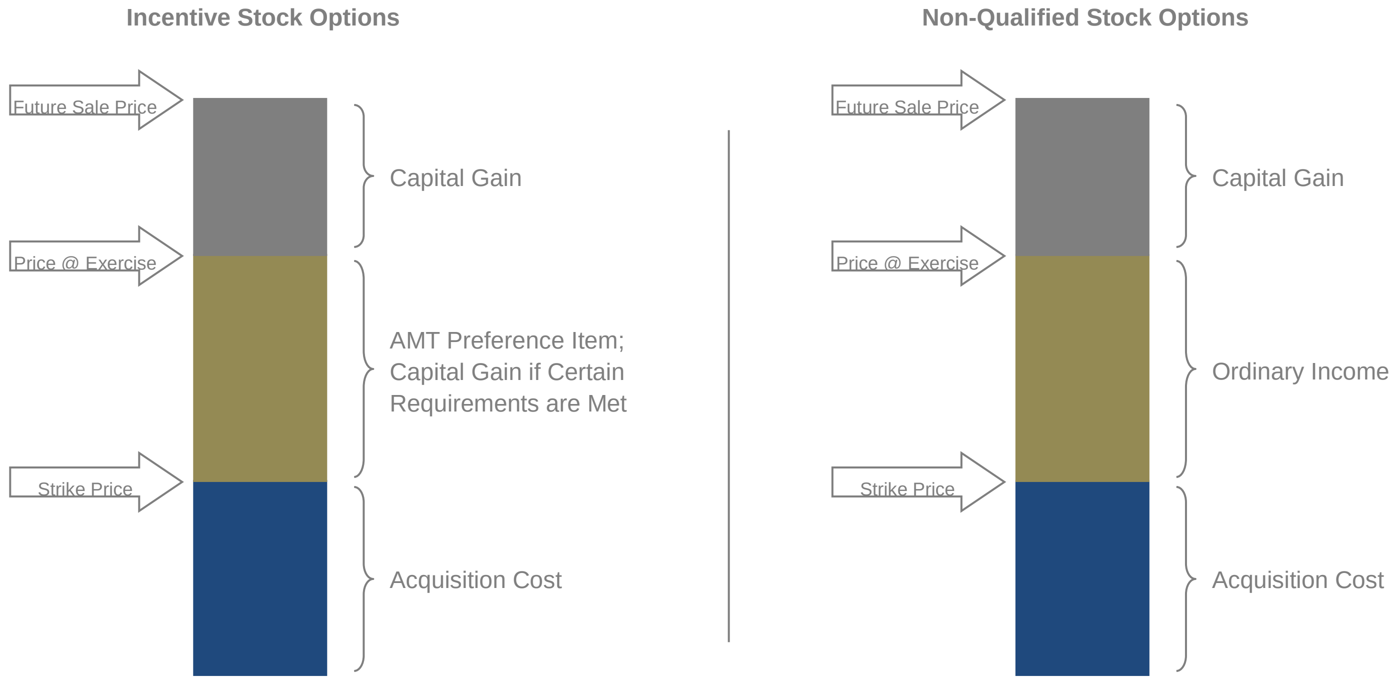
Stock that is acquired through the exercise of an ISO and is not held for the time period set forth in IRC Section 422 noted above will be considered a disqualifying disposition and ordinary income rates will be assessed on the value between the strike price and sale price, reverting to the tax treatment of non-qualified stock options.

Non-Qualified Stock Options

Non-Qualified stock options do not have any requirements to fulfill and are much more straightforward than ISOs.

Like ISOs, no tax is due when non-qualified stock options are granted. However, unlike ISOs, ordinary income tax is assessed upon the exercise of non-qualified stock options on the value between the strike price and the fair market value of the stock on the date of exercise. When the stock is ultimately sold, capital gains rates will apply on the value between the fair market value on the date of exercise and the sale price.

Illustrative Tax Implications



Exercising Stock Options

When employer stock options are exercised, the individual exercising the option will be required to pay the plan administrator for the exercise. An amount equal to the strike price will be due for each share that is being acquired.

In the case of non-qualified stock options, federal, state, and FICA taxes will also be due upon exercise. Federal, state, and FICA taxes will be assessed on the options' intrinsic value, or the amount by which the underlying stock's price exceeds the option's strike price. The cost of exercising employee stock options can be substantial.

Here, we will address several methods of exercising which do not require the option holder to pay "out-of-pocket."

Cashless Exercise

In a cashless exercise, immediately following the exercise the executive sells enough of the newly acquired stock to pay the cost of the exercise - including federal, state, and FICA taxes. The remaining shares can be retained or sold, representing the net value retained by the option holder.

This method is appropriate for non-qualified stock options as shares acquired through an ISO exercise are only eligible for long-term capital gains treatment if they are held for at least one year from exercise and two years from grant.

Stock Swaps

In a stock swap, the option holder pays for the exercise with shares of company stock rather than cash. In order for this to be a viable alternative, the plan must allow stock swaps as a method of exercising and the option holder must own a sufficient number of shares outright.

When a stock swap is completed the option holder will receive the number of shares specified in the option grant. Of the newly acquired shares, a number of shares that equals the amount of shares swapped to fund the exercise will retain the cost basis and acquisition date of the swapped shares. All of the remaining shares will have a cost basis of zero and an acquisition date equal to the exercise date.

For example, an employee has an ISO for 5,000 shares of XYZ stock with a strike price of $25. The employee owns 2,500 shares of XYZ outright (with a cost basis of $5 and an acquisition date of 1/1/2001) and the stock is currently trading at $50 per share.

The cost to exercise is $125,000 (5,000 shares * $25) and the employee swaps the shares owned outright (2,500 * $50 = $125,000) to pay for the exercise. The newly acquired 5,000 shares have the following cost basis:

- 2,500 shares with a cost basis of $5 and an acquisition date of 1/1/2001
- 2,500 shares with a cost basis of $0 and an acquisition date equal to the exercise date

For option holders who own a significant amount of their employer stock outright, a stock swap may be an effective way to address concentration risk.

Margin Loans

Another method to fund the exercise of stock options is a margin loan. An individual can obtain a margin loan from their brokerage firm. The Federal Reserve Board created Regulation T (Reg T) to govern margin loans, which states that a client may borrow up to 50% of the value of their marginable securities.

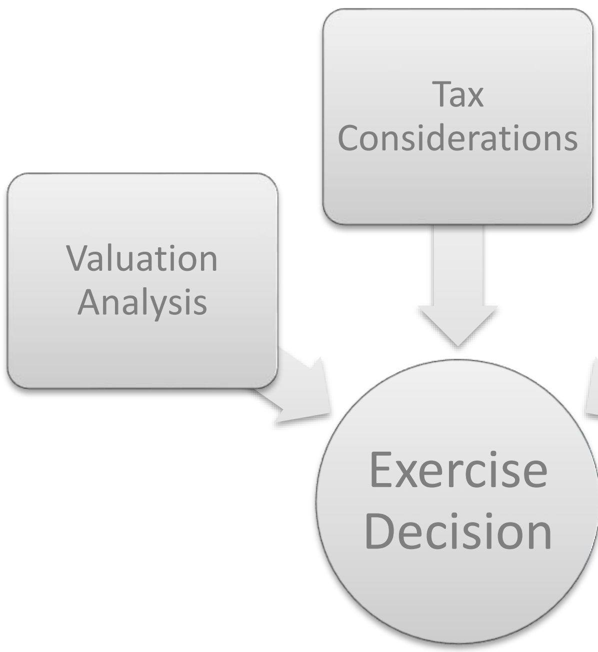
In order to fund a stock option exercise with a margin loan, the cost of the exercise must first be determined. This will include the strike price per share and, in the case of non-qualified stock options, estimated federal, state, and FICA taxes. Once the cost is determined, securities with a value equal to twice the cost must be on deposit at the brokerage firm. The market value of the stock that will be acquired through exercise will included in the value of assets to be borrowed against.

However, if the total value of those shares plus any other securities on deposit do not equal twice the required loan amount then a deposit of additional assets will be necessary.

Please consult with your financial advisor for a complete description of the requirements and considerations of a margin loan.

Deciding When to Exercise

The decision of when to exercise includes many factors. A common opinion is to hold options until expiration and exercise at the last minute. While easy to execute, this method ignores many of the planning factors that should be included in the exercise decision. We recommend incorporating three levels of analysis when assessing whether an option grant should be exercised. These levels include the option's valuation, tax ramifications of exercising and how the options fit into the individual's broader risk tolerance.



Stock Option Valuation

The most common way to value an option contract is by using an option pricing model. While there are several versions of option pricing models available, the most frequently used is the Black-Scholes Option Pricing Model. This model uses inputs including the stock's current price, the option's strike price, interest rates and the assumed volatility of the stock for the duration of the option's life to compute a theoretical value for the option.

The option's price can consist of two parts.

- Intrinsic value: the positive difference between the stock's market price and option's strike price, otherwise known as the in-the-money amount; for options with a strike price higher than the current stock price, there is no intrinsic value
- Time value: the theoretical value of the time remaining until the option expires; time value will decline over time however the proximity of the stock's market price to the option's strike price also impacts the magnitude of time value changes

By using a pricing model, the executive can weigh both the value that can be captured immediately through exercise and the value of the time remaining until expiration. This provides the employee a practical approach to deciding which options to exercise.

Taxes and Option Exercise

As mentioned previously, the tax ramifications of exercising non-qualified stock options are straightforward. The executive pays federal, state and FICA taxes on the intrinsic value at exercise.

The tax considerations for ISOs are more complicated. While the executive pays no taxes upon exercise under the regular tax system, there can be implications under the AMT system due to the intrinsic value of the option at exercise being treated as a preference item under AMT. Thus, careful planning must go into the timing of ISO exercise to ensure the executive avoids unwanted AMT exposure.

Techniques including spreading ISO exercise across several years or "bunching" personal tax deductions into one year to allow for a larger ISO exercise in a following year can be used to help in the planning process.

Risk Tolerance and Options

Option grants often contribute to an executive's larger concentration in employer stock. Exercising options via a cashless exercise that involves selling all of the underlying shares may be a way to reduce the concentrated position more effectively than selling shares owned outright with a lower cost basis.

Stock Grants

There are four common types of stock grants: restricted stock, restricted stock units (RSUs), performance share units (PSUs) and stock appreciation rights (SARs).

- Restricted stock grants are awards of stock to employees that are "locked-up" for a predefined period before they become the full possession of the executive upon vesting and the payment of the appropriate tax withholdings; employees typically do not pay a strike price to acquire restricted stock shares like with option grants but may receive dividends and exercise voting rights during the vesting period

- Restricted stock units (RSUs) are similar to restricted stock grants other than the accounting treatment recognized by the company when granting the award to employees; RSUs can also be settled in cash or stock, meaning the employee may end up with either a net stock position or a cash amount after the award vests and tax withholdings are taken

- Performance share units (PSUs) are similar in accounting treatment to RSUs, however the number of units awarded is ultimately decided by certain performance measures. These awards are typically given with a cliff vesting schedule, meaning several years have to pass before they vest. At the time of vesting, the company measures certain financial metrics versus some benchmark and if the number of shares ultimately awarded can be reduced or increased from the original grant amount depending on the company's underperformance or outperformance versus the benchmark.

- Stock appreciation rights (SARs) are usually cash settled and the employee only participates in and is taxed on the net stock price appreciation between the time of grant and vesting; if the stock price trades down during the vesting period, the employee typically receives no benefit

Other names used for similar awards include Phantom Stock or Performance Units, among others. Also, grants may have features including multipliers that increase the number of shares awarded if certain performance measures are met.

Stock Grant Terminology

All stock grants have the same basic variables.

- Grant date: the date on which the award is given to the employee
- Vesting date: the date on which the grant becomes the possession of the employee; this may be a specific date or dates or rely on meeting certain performance measures
- Underlying shares: the number of shares that are acquired at vesting

Taxes and Stock Grants

The most common tax impact of stock grants is that the employee must pay federal, state and FICA taxes on the market value of the stock, less anything paid to acquire the stock grant (typically $0), on the vesting date.

The tax withholding due upon the vesting of SARs is slightly different in that it is only measured on the value of any stock price appreciation between the time of grant and vesting. Also, because they are usually settled in cash, the employee receives a payment net of tax withholding instead of having to pay the taxes another way.

There is little an executive can do to plan for the tax impact of vesting other than to be aware of when vesting will happen and arrange to pay for the taxes, potentially by selling some of the vested shares.

If the employee is subject to corporate trading windows, the use of a 10b5-1 plan may allow for the sale of shares to cover the tax withholding of future restricted stock awards.

Additionally, there may be charitable techniques that can mitigate or reduce some of the tax impact for those inclined to gift assets.

The 83(b) Election

The one planning decision to make with regards to stock grants is specific to restricted stock only. By making an 83(b) election, an executive can pay federal, state and FICA taxes on the market price of the stock at the time of grant instead of at the time of vesting.

The 83(b) election can only be made within 30 days of receiving the restricted stock grant, so the planning process needs to begin prior to, or shortly after, receiving the award.

This technique is appropriate when the executive anticipates significant price appreciation during the vesting period. If this were to occur, electing 83(b) will convert the price appreciation into a long-term capital gain, which is typically taxed at a lower rate than ordinary income.

This election does not come without risk however. If the stock price were to decline during the vesting period, the executive may have paid more in ordinary taxes than would have been required had the election not been made.

Additionally, restricted stock grants are typically forfeited if the executive leaves the company prior to vesting. If this were to happen, there is no refund of the taxes paid upon making the 83(b) election.

As an alternate approach, the executive can use the money that would go to pay taxes upon the 83(b) election to buy additional shares. This may result in a larger after-tax benefit to the executive depending on how the stock performs. This technique needs to be carefully considered as it involves additional risk due to the larger concentration in employer stock.

Other Types of Equity Compensation

Each company has its own set of equity compensation awards that it provides to employees. Those discussed previously are the most common across all companies but there are other types that may be used.

Tradable Stock Options

While less prevalent, some companies offer employees tradable non-qualified stock options. These are identical to traditional NQSOs with the exception that they can be sold through a specified broker/dealer for the computed option value as calculated by an option pricing model. This offers greater liquidity than traditional NQSOs as even options that are "underwater" (the strike price is greater than the stock's market price) can be sold for some value.

Employee Stock Ownership Plans (ESOPs)

ESOPs are a type of employee benefit typically provided to all full-time employees over 21 years of age whereby the company allocates an amount of stock to each individual based on the basis of relative compensation or other formula. When an employee leaves the company, they receive the balance of their vested ESOP shares or their cash equivalent.

Employee Stock Purchase Plans (ESPPs)

ESPPs typically allow all employees to purchase shares of company stock, usually at a 15% discount to the prevailing market price. The shares are not awarded to employees; rather the employee elects to purchase stock. But the fact that the shares are purchased at a discount to the stock's market price means that this is another form of equity based benefit offered to employees of publicly traded companies.

It should be noted that the discount received at purchase may be treated as an ordinary income event upon disposition of the stock. The tax consequences will vary based on the timing of the sale and if it is considered a qualifying or disqualifying disposition. This treatment is driven by holding period measurements similar to those affecting the sale of ISO shares.

401(k) Contribution Matches & Profit Sharing Plans

Another way companies use stock to reward employees is through 401(k) matches and Profit Sharing Plans (PSP) funded with company stock. Most companies offer a match on a predefined level of employee 401(k) contributions. Additionally, some companies offer employees the benefit of participating in annual company profits through a PSP. The value of PSP awards can be funded with company stock. These techniques may both involve company stock, making them additional factors to consider when analyzing the executive's total exposure to employer stock.

Net Unrealized Appreciation (NUA)

It is not uncommon for executives to accrue a large amount of employer stock within company sponsored programs like ESPPs, ESOPs, PSPs and 401(k) plans.

Upon departing from the company, it may appear the best option is to roll the shares into a self-directed traditional IRA, because this is a tax-free transaction. In this scenario, no tax is incurred until a distribution is taken from the IRA. At that time, the entire distribution is taxed at ordinary income rates assuming the employee is at least 59 ½ years old. However, rolling the shares into an IRA eliminates the opportunity to benefit from the net unrealized appreciation (NUA) embedded in the stock.

For example, if an individual chooses to take a lump-sum distribution from his or her qualified plan and deposits the employer stock in a regular taxable brokerage account, he or she may ultimately pay less in taxes since only the cost basis of the stock is taxed at ordinary rates upon transfer. The value between the cost basis and the fair market value at the time of the transfer (the NUA) is not taxed until the position is sold. At that time, it is taxed at prevailing capital gains rates.

This strategy is only appropriate when the cost basis is relatively low compared to the total value of the stock position.

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