



ANAHEIM
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The Annual Conference of the Financial Planning Community

TRACK:	<i>WEALTH & INVESTMENT MANAGEMENT</i>
SESSION: 979058	STOCK OPTIONS AND GRANTS: THE ADVISOR'S GUIDE TO EQUITY COMPENSATION
	TUESDAY, OCTOBER 13, 2009
	8:45 AM -10:15 AM
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Pete is President and Chief Executive Officer of Wheeler/Frost Associates, Inc. and founder and Managing Director of FamilyOfficeNetwork, LLC. He has over forty years of experience in the financial services industry. Serving the needs of the owners of successful privately held corporations, Pete has a particular expertise in employee stock options and grants and is the author of *Stock Options + Grants: The Executive's Guide to Equity Compensation* and *An Executive's Guide: Incentive and Nonqualified Stock Options*. He has been a speaker on stock options and grants at the FPA's Retreat and NAPFA's annual convention. Pete is also a contributing author for *Strictly Business – Planning Strategies for Privately Owned Businesses*. In 2000, Pete founded FamilyOfficeNetwork L.L.C. and serves as Managing Director. FamilyOfficeNetwork enables independent advisors to offer comprehensive wealth management services to their clients through an Internet based information-sharing environment. Pete is recognized for his advanced knowledge in insurance, estate, business, and pension planning, and has been featured on numerous television and radio programs and in many financial publications. He was selected as one of the top 250 financial advisors in the nation by *Worth* magazine and was the cover story for *Financial Advisor* magazine's February 2003 issue. He has been listed as one of the "Top Wealth Managers" every year by *Bloomberg's Wealth Manager Magazine*.

FPA Annual Conference
October 13, 2009

***Stock Options and Grants:
The Advisor's Guide to
Equity Compensation***

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Acknowledgements

Much of the information contained in this presentation deals with advanced tax issues. The presenter is not a tax expert and offers no tax advise as part of this presentation.

Special appreciation is extended to Mr. Bruce Brumberg, Editor-in-Chief, myStockOptions.com for sharing his presentation on Restricted Stock & Trends in Equity Compensation for inclusion in this presentation.

Presentation Outline

- Overview of equity compensation
- Restricted stock/RSU grants
- Other types of grants: performance shares and stock appreciation rights
- Related topics in stock compensation financial planning: Rule 10b5-1 trading plans, 83b election
- Underwater options; Divorce
- Planning
- Trends in equity compensation

Why advisors should know about equity and performance based compensation

- Attract prospects by helping them to better understand their compensation benefits
- Secure clients by providing them with ongoing assistance to manage their portfolio
- Help clients make timely diversification decisions
- Optimize diversification decisions for tax & cash flow efficiency
- Grow business through referrals and reputation

Shocking Statistics

- 11% of options expire “In the Money”
- 75% of holders of ISOs don’t know about AMT
- 74% said they know very little about their stock options
- Option holders know more about Einstein’s “Theory of Relativity” than their options

Oppenheimer Funds Study 1999

Incentive Compensation

- Deferred Compensation
- Stock Appreciation Rights (SARs)
- Phantom Stock
- Employee Stock Purchase Plan
- Restricted Stock Plans
- Nonqualified Stock Option
- Incentive Stock Option

SARs and Phantom Stock

- Not actual ownership of the company's stock
- Grant a right in the future appreciation of the company if the employee is still employed at the triggering event
- Closely held company
- Unlimited variety of plan designs

Restricted Stock Plans

- Stock grants (awards)
- Subject to vesting and restrictions on sale
- Microsoft plan
- Unlimited design options
- Taxation issues for company and employee

Restricted stock units (RSUs)

- Stock is not issued or outstanding until release of shares at vesting
- Holders of RSUs have no voting rights.
- Dividends (i.e., equivalents) not required as RSU-holders are not shareholders.
 - Microsoft does not pay dividends on RSUs. General Electric does.
- Share delivery occurs at vesting, withholding for the taxes.
- Some RSU plans have a deferral feature that lets you select a date for share delivery, or one specified by company (e.g., retirement). Need to follow all the guidance and rules for deferred compensation elections under 409A.
- Social Security and Medicare at vesting with deferrals, with ordinary income when shares later delivered.

Why companies use RSUs instead of restricted stock for grants?

- No 83(b) election.
- No administrative burdens for company or employee risks.
- Can avoid paying cash dividends during the vesting period.
- No tax at grant in countries where tax not delayed until vesting.
- No shares issued at grant.
- Specialized RSU plans defer delivery of the shares (not at vesting) until date specified by executives or termination of employment. Need to follow AJCA guidance from IRS/Treasury.

Stock appreciation rights

- Rights company grants that entitle you to receive the appreciation in value of shares of its stock from the grant date.
- Instead of exercising a stock option, you exercise the SAR.
- Depending on the plan's design, you receive in either cash or stock the spread between the exercise price and the fair market value on the date of exercise. Stock-settled SARs more popular.
- All the other rules and financial-planning considerations are similar to those of stock options. Less dilution for companies and shareholders. Private companies also use them instead of having to issue stock when appreciation paid in cash.
- This spread at exercise is ordinary income, taxed similarly to that of NOSOs. Withholding at exercise, though company may automatically "withhold" shares to cover the taxes.

Employee Stock Purchase Plan

- The employee is able to purchase the employer's stock at a discount
- Qualified – IRC Section 423
- Non-qualified – no tax benefits
- Discount usually 15% from current market
- Qualified plan taxed like ISOs

Stock Options

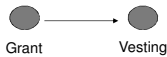
- A right granted to an individual allowing him/her to purchase a specified number of shares of a stock at a stated price within a given time period.
- Rights and Obligations:
 - The holder has unfettered discretion to exercise or not to exercise
 - If the holder exercises the option, the grantor is bound to perform
- Economics:
 - The economic deal must be such that, at the time of grant, the option has a realistic chance of being exercised and a realistic chance of being allowed to lapse

The Grant Process - Grant



- Grant: the date on which the option or award is given to the employee, setting the price and terms

Vesting



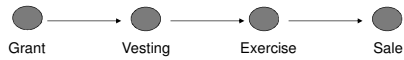
- Vesting: the delay before a stock option can be exercised or a stock grant vests
- The employee's performance of services during the vesting period acts as a substitute for the employee's payment for the option or the grant

Exercise



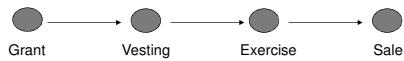
- Exercise: the acquisition of the shares through the exercise of the options

Sale



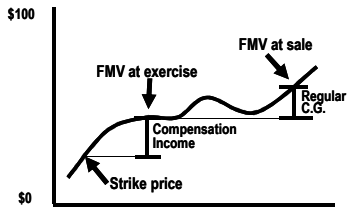
- Sale: the disposition of the shares acquired from the exercise of your options or receipt of a grant

Taxation of Nonqualified Stock Options

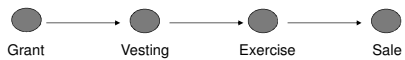


- Grant- no tax
- Vesting- no tax
- Exercise- income and payroll taxes on difference between exercise price and FMV (spread)
- Sale- tax on capital gains

NQSOs: Tax Consequences

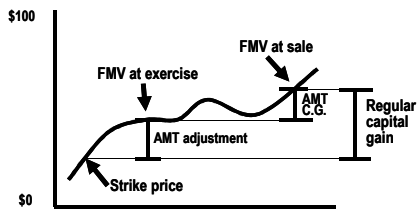


Taxation of Incentive Stock Options



- Grant- no tax
- Vesting- no tax
- Exercise- no tax on spread, may be subject to the Alternative Minimum Tax (AMT)
- Sale- tax on capital gains and possible AMT credit

ISOs: Tax Consequences



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Taxation of Stock Grants



- Grant- no tax
- Vesting- Tax on FMV
- Sale – Tax on Capital Gain
- A stock grant is completed at vesting and does not require exercise

Taxation of Stock Awards

Stock Awards are taxed at FMV at time of receipt if vested.

If not vested, then at FMV at time of vesting.

“In the case of stock awards that take the form of the Company’s unfunded and unsecured promise to issue common stock at a future date, the grant... is not a taxable event...”

Evaluating Alternatives

- Diversification strategies:
 - Comparing various diversification rates & prices
- Cash flow strategies:
 - Illustrating the effects of exercising & selling
 - Financing the diversification strategy
- Tax strategies:
 - Exercising & holding ISO to get capital gains rates
 - Disqualifying disposition

Optimizing Alternatives

- Tax optimization:
 - Disqualify disposition analysis
 - Exercising ISOs up to AMT limit
- Cash flow optimization:
 - Achieving an after-tax cash flow amount
 - Achieving an after-tax diversification percentage

Planning Opportunities

- Cash flow management strategies
 - Financing the exercise costs
 - Tax and timing strategies
 - Planning for cash flow needs
- Risk reduction strategies:
 - Minimize downside risk versus upside potential
 - Address downside effects of leverage
 - Reduce concentrated positions
- Diversification strategies:
 - Reducing the exposure to option positions
 - Dollar cost averaging

Underwater stock options

- Companies considering option exchanges for new options, restricted stock, or cash. Cancellation of underwater options followed by immediate new grant. **Formal election procedure and timeline your clients need to follow.**
- Not as easy to do as after the last big market drop (2000-2002). Unpopular with investors; usually needs shareholder approval; SEC filings (Schedule TO, which requires offer to be open at least 20 business days).
- Accounting rules create “incentive” for companies to consider exchanges: Reuse earnings charge and no new expense when “value-for-value” exchange. One-to-one rare (Google exception).
- Conditions for shareholder approval: senior executives excluded and new vesting changed. Only exchange options with exercise price above 52-week high.

Solutions for Underwater Options

- Wait and See
 - No choice
 - No tax consequence
- Accelerate Grants
 - Company's option
 - No tax consequence
- Restricted Stock
 - Trade options for restricted stock
 - Shares are restricted
 - Company has fixed cost

Solutions for Underwater Options

- Cancel and Replace Options
 - Six months and a day
 - Market risk
- Trade Options for Deferred Compensation
 - Unsecured creditor
- Buy Out for Cash
 - Company has fixed cost
- Sell Options to Third Party
 - Company may not allow
 - Microsoft plan

Underwater stock options

As of late March 2009, HR consulting firm Radford found that the most common treatments (115 companies, with 63 in technology) involve exchanging options for:

Grant type	% Used
Options	48%
Restricted stock	34%
Cash	14%
Combo	3%

Divorce and Stock Options

- Opportunities for advisors in divorce planning with stock options
 - Divorce attorneys are not knowledgeable
 - Tax attorneys may not know about options and equity compensation
 - Need to gather and understand information
 - Tax planning that must be done
 - Assets to be invested

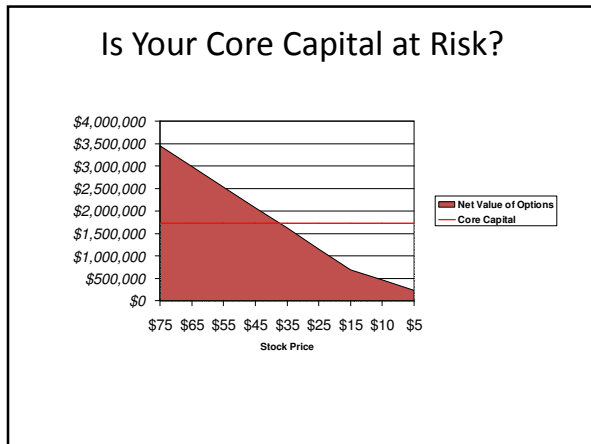
Divorce and Stock Options

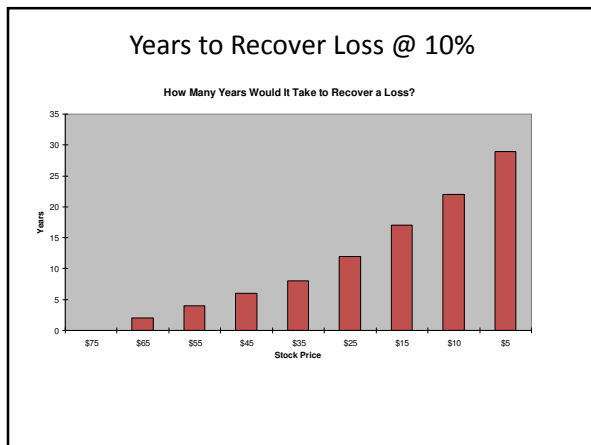
- Options may be an asset of the community estate
- CA – Hug – The Time Rule
- CN – Kiniry – Earned during marriage
- NJ – Pascale – Attributable to marriage
- Not subject to a QUDRO

Core Capital™ Concept

Financial planning 101

Help your clients see the value of a well planned strategy to reduce their risk of having all of their assets and income tied up in a single company.





- ### Planning Considerations
- Cashless exercise
 - Exercise more shares to start capital gains clock
 - Exercise some ISOs to stay under AMT threshold
 - Stock Swap / Reload
 - Concentrated equity exposure
 - Timing
 - Exercise ISOs early in the year
 - Review ISOs before year end
 - Pre-pay State Income Taxes
 - Run the numbers
 - Watch out for the Greed Factor

Planning Considerations

- Section 83b election
- Rule 144
- Section 16
- Systematic Plan – Rule 10b5-1
- Charitable Gift
- Section 409A
- Section 457A

83(b) Election

- Avoid future AMT.
- May reduce tax liability in NQ and ISO scenario (100% capital gain).
- Must be filed within 30 days of grant.

Risk with 83b Election

- *Very few employees/executives make the election with public company grants.*
- *You leave the company, and restricted stock never vested. Cannot recover taxes paid.*
- *Stock price dropped after election: you cannot recover taxes paid with 83(b) election.*
- *Can't rescind election.*
- *Consider using tax dollars to buy stock on open market. Need to run the numbers.*
- *Low/depressed stock price and higher tax rates ahead could impact analysis.*

Withholding taxes on restricted stock

- Subject to tax withholding at vesting or 83(b) filing.
- Compensation income similar to NQSO treatment on spread at exercise. 25% supplemental income tax rate, state (if have income tax), Social Security/Medicare: **familiar W-2 reporting**
- Amount is withheld from salary, cash payment made, sell-to-cover, or company may allow (or require) share withholding. Trend towards automatic share surrender.
- Issues with automatic share withholding: how to handle fractional shares; company needs to have the cash to pay IRS for the withholding taxes, as no shares sold to generate the funds.
- With share withholding/surrender, employees may have additional reporting for securities sale on Schedule D of tax return.

Dividends on restricted stock

- Dividends on unvested shares are compensation income reported on W-2. They are not "qualified dividends" taxed at lower rates until vested.
- Dividends when timely 83(b) election at grant causes dividends to be "qualified" and reported on 1099-DIV.
- Approximately 10% pay dividends in more shares, although not received until underlying shares vest.

ISO Disqualifying Disposition

- Only ISOs
- Value has declined in year of exercise
- Tax savings
- Watch "wash sale" rules - 31 days

EXAMPLE 3 - ISO DISQUALIFYING DISPOSITION

- Exercise 2,000 shares 7/2/09
- Exercise price - \$20
- Fair market value - \$50
- Sell 2,000 shares 12/31/09 - \$30
- Versus sell 2,000 shares 7/3/10 - \$30

EXAMPLE 3 - ISO DISQUALIFYING DISPOSITION

	2009		2010	
	ISO	ISO DISQUALIFYING DISPOSITION	ISO	ISO DISQUALIFYING DISPOSITION
Value of stock	100,000	100,000		
Exercise cost	40,000	40,000		
	-----	-----	-----	-----
Income from exercise/sale	0	0	20,000	0
Disqualifying disposition		20,000	N/A	N/A
Federal tax	30,829	37,750	34,484	29,536
AMT	16,071	0	(8,679)	0
	-----	-----	-----	-----
Total Fed Tax	46,900	37,750	25,805	29,536

EXAMPLE 3 - ISO DISQUALIFYING DISPOSITION

OVER A 2 YEAR PERIOD	
ISO -	\$ 72,705
ISO Disqualifying disposition -	67,286

Savings	\$ 5,419
	===== 7.5% Savings

Rule 10b5-1 trading plans

Executive adopts a written plan for periodically trading a specific amount of securities at set prices and/or times. Available for anyone (directors, investors), not just insiders. *Must be unaware of inside information when enter into plan!*

These plans can provide an affirmative defense (not a shield) for anyone with stock (e.g., insiders, founders, large shareholders) against insider trading claims.

How do 10b5-1 plans help?

- Sales can take place even when insiders are aware of material nonpublic information and during blackouts.
- You can set plans up to use the stock proceeds for specific known financial needs, such as college tuition. Allows implementation of diversification plan set up by financial advisor.
- Can head off media criticism and analysts' questions about trades, particularly when sales occur before bad news.
- Can be used for prearranged sales of shares for taxes with restricted stock/RSU vesting.

Section 409A

- Section 409A applies only to deferred compensation, which generally is defined as compensation that isor may be payable later than the year in which the legally binding right to the compensation arises.
- When an employee has a legally binding right to a bonus, the failure to pay the bonus by Mar. 15 of the following year is not a violation of 409A provided the employee is subject to a substantial risk of forfeiture (SROF).

Section 409A

- Nonqualified deferred compensation arrangements, including severance, employment, bonus, change in control, traditional deferred compensation and equity compensation arrangements are covered by Sec. 409A.
- Stock options and stock appreciation rights granted below the fair market value of the underlying shares of stock on the date of grant generally will violate Sec. 409A.

Section 409A

- Some options to correct errors and avoid penalties.
- Failure to comply with Sec. 409A results in 20% penalty tax and interest charged at 1% higher than the penalty rate.

Section 457A

Emergency Economic Stabilization Act of 2008

- Generally, 457A provides that a non-qualified deferred compensation arrangement sponsored by a non-qualified entity is includible in taxable income when the deferred amount is no longer subject to a SROF.
- If the deferred amount is not determinable at that time, the amount will be subject to an additional 20% tax plus “a premium interest factor” when it becomes determinable.

Section 457A

- SROF narrowly defined: “only if the service provider’s right to the compensation is ‘conditioned upon the future performance of substantial services’ by the service provider.”
- Definition of “nonqualified entity” is determined annually on the last day of the service provider’s taxable year in which the nonqualified deferred compensation was no longer subject to a substantial risk of forfeiture.

Problems in Paradise

- Generally, 2/3 of GDP wages, 1/3 capital
- Incentive comp. distortion:
 - 1999 Stock options - 47% of comp.
 - 2006 Stock options - 81% of comp.
- Typical comp. largest public companies
 - Salary \$1 million - \$3 million
 - Cash bonus \$10 mil - \$15 mil
 - Stock bonus highest \$20 mil
 - Stock Option highest exercised \$100 mil - \$200 mil

Trends in equity compensation: PricewaterhouseCoopers 2007 survey

PwC's survey of 152 multinational companies revealed:

- Nearly 50% of the companies have shifted from granting only stock options to granting other types of equity compensation as well.
- 40% of companies still do not expect to make any changes in their stock option plans because of expensing.
- About 8% are exploring alternatives.

Among the companies that have made changes:

- Just under 20% have reduced grant levels.
- Just over 20% have restricted the eligibility for grants.
- About 5% have eliminated some or all of their stock plans.

2009 Survey

Buck Consulting Survey ("Taking The Pulse Of Equity Compensation") on what companies have implemented or plan to implement in 2009.

- 31% of companies expect to somewhat increase the number of options or shares in 2009. Very few intend to fully restore last year's value.
- At companies issuing equity compensation based on a number of shares, 60% anticipate no change in awards. At companies making grants on a dollar-value basis, only 30% expect no changes in awards.
- 45% considering a change in equity compensation mix.
- 29% will increase use of shares and decrease use of options
- 16% will increase their use of options and decrease use of shares. Firm notes that this creates the "possibility of delivering more future value from the increased number of options granted."

Companies moving from options to SARs

From proxy of **American Airlines**: "As part of its 2006 compensation review, the Compensation Committee decided to replace stock option grants to our officers (including our current named executive officers) with grants of stock settled stock appreciation rights (SSARs) because SSARs require the use of fewer shares from the LTIP upon their exercise, while delivering the same economic value to the recipients as stock options. Similar to stock options, SSARs provide value when the price of our stock exceeds the exercise price of the SSAR. We pay the value of the appreciation in an equivalent number of shares of our stock."

"SSARs are exercisable for ten years from the date of grant, have a grant price equal to the fair market value of our common stock on the date of grant, and vest in 20% increments over five years (unless the recipient dies, in which case vesting is accelerated)."

Changes in ESPPs

- Accounting rule change has impacted tax-qualified (IRC Section 423) ESPPs. Other than companies making no changes at all, biggest modifications are: reducing the discount; shortening the lookback period; and even ending the plan completely.
- Examples: Dell shortened its purchase period to three months and eliminated the lookback. Kept the purchase price at 85% of the price on the last day of the purchase period.
- Microsoft eliminated its lookback and changed its discount. Uses three-month purchase periods (previously six) with a 10% discount based on the stock price on the last day of each three-month period.

Changes in ESPPs

- Reducing or eliminating the lookback has the greatest impact on the earnings charge.
- Plan design does appear to affect enrollment in ESPPs.
- Fidelity Stock Plan Services examined participation rates at ESPPs that it administers. Lowering the discount to 5% caused the average participation rate to drop by 50%. However, lowering the discount to 10%, removing the lookback, or shortening the offering period had no substantial impact on plan participation.

**Performance shares:
growth in grants to top executives**

- Payout in shares earned by meeting targets. Can be all or nothing or scale. Part of long-term incentive plan (LTIP).
- **Three parts:** The goal, the period for reaching it, the target award size (and any sliding scale with substantial upside).
- Performance shares are not issued up front. The grant is taxed at payout as ordinary income similar to restricted stock at vesting. Some plans give choice to defer payout and thus taxes, when elections properly made.
- **Performance goals:** Other than company specific targets (e.g., product development milestones, levels of customer satisfaction), common performance targets include total shareholder return (TSR), earnings per share (EPS), sales, return on assets, return on equity. Customized and variation among companies.

Example: Instead of granting you 2,000 shares of restricted stock that vest 25% a year on the anniversary of the date when your employment started, your company grants you 2,000 performance shares that will result in 2,000 shares when the earnings per share (EPS) of your company grow by 30% at the end of three years.

**Just at beginning of new trends:
what lies ahead**

Changes in executive and equity pay practices that are "far more wrenching" than those caused by the 2000–2002 market drop:

- More companies are affected.
- Stricter rules on disclosure and shareholder approval, and much more aggressive public and media attention.
- Changes expected in various laws that could expand beyond financial institutions accepting TARP money, such as \$500,000 limit and performance-based exception.
- Economic downturn with high employment challenges the importance of "recruitment, retention, motivation" goals of equity compensation.
- Tax hikes for higher income brackets in 2011 increases interest in compensation with deferral features, such as stock options and RSUs with deferral of share delivery.
- Other tax changes for Social Security shortfall or new type of qualified stock grant.

Say on Pay

- Corporate and Financial Institution Compensation Fairness Act of 2009 (H.R. 3269)
- Annual non-binding shareholder approval of executive comp.
- Disclosure of compensation to principal executives.
- Separate non-binding shareholder approval of disclosed compensation to principal executives.
- Separate vote on golden parachutes.
- Independent members of compensation committees.
- Independent compensation consultants and legal counsel.
- Proxy disclosure of whether or not independent services were used and if not why not.
- Penalty – SEC delisting from exchange.

Summary of equity compensation trends important to advisors

- Rank-and-file employees and executives receiving fewer options and eligibility shrinking, yet grants still meaningful. Remains an important part of the compensation philosophy and approach at public and growing private companies. Important wealth-builder.
- Stock grants continue at higher levels (e.g., management and executives) as important part of long-term incentive compensation. **Look at company's proxy statement; annual report footnotes; and Section 16 Forms 3,4,5 for details on grants to executives.**
- Equity grants at companies have changed from being all stock options to being a mix of other types: restricted stock, restricted stock units, stock appreciation rights (SARs), and performance shares. **Makes financial planning more complex.**
- Substantial number of stock options still outstanding and companies remain committed to them. Companies looking at what to do about underwater stock options.

Tax Issues

- Complexity
- Regular Tax
- Alternative Minimum Tax (AMT)
- Few rules of thumb
- Analysis required

Tax Planning

- **A must!** Run numbers.
- Influences decisions of other deductions/income
- **AMT**
- Cash flow requirements.
- Financial/investment management partner.

Summary

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- Restricted stock/RSU grants
- Other types of grants: performance shares and stock appreciation rights
- Related topics in stock compensation financial planning: Rule 10b5-1 trading plans, 83b election
- Underwater options; Divorce
- Planning
- Trends in equity compensation

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