KLS PROFESSIONAL ADVISORS GROUP, LLC

SENIOR EXECUTIVE COMPENSATION

Managing the concentration of one's wealth in the securities of an employer is a critical issue in an environment in which:

- Annual executive compensation includes a substantial weighting in employer stock and options
- Matching contributions in 401(k) plans are often required to be invested in employer stock
- Executives are required to own a minimum number of shares in the employer company as a condition of employment
- Limited window periods for senior executives to trade employer company shares, coupled with volatility in the stock market, results in liquidity restrictions and time/valuation pressures.

The optimal course of action for any individual executive must, of course, be sensitive to their particular financial situation, including their overall investment portfolio, cash flow and liquidity, and any special circumstances that might impact their risk tolerance. Nonetheless, experience has taught that managing exposure to employer company securities, and undertaking a tax-efficient program of diversification, can enhance the executive's risk-adjusted rate of return.

Restricted Stock Grants

Generally, as an executive continues to vest in restricted shares, such shares should be sold. Many companies facilitate this by arranging vesting schedules to coincide with window periods. The advantage of selling at this time is the dollar-for-dollar reduction of investment exposure to employer stock at a time when cash is required to pay the ordinary income tax liability associated with the vesting of shares. Because the basis of the shares sold is the value included in taxable income upon vesting, there should not be material additional income tax consequence upon sale.

The recommended approach of selling shares upon attaining taxability leaves open the question of whether to make a Section 83(b) election. Section 83(b) is an Internal Revenue Code provision that allows the recipient of shares to elect to recognize as ordinary income the value of such shares at grant date notwithstanding that they are subject to forfeiture if certain employment conditions are not satisfied. Where the election is made, all future appreciation or decline in value realized upon sale will be recognized as capital gain or loss.

In addressing the advisability of making an 83(b) election, a sobering look back to the results realized by many executives who made such elections prior to the bursting of the "technology bubble" is worthwhile. These elections often resulted in ordinary income tax attributable to high share prices that could not be realized through sale due to grant restrictions, rapidly declining share prices, and securities law restrictions. The capital losses that resulted could only offset capital gains (all too frequently non-existent) rather than ordinary income. Further, there were many cases where share value realized upon sale was

insufficient to fund even the income tax liability resulting from the election. In short, when thinking about Section 83(b) elections, think "downside risk."

Stock Ownership Requirements

Stock ownership requirements for senior executives are often mandated by employers to ensure that executives participate not only in the upside resulting from increase in share price, but also participate in the downside should share price decline. Many employers provide that share ownership requirements may be satisfied both by direct ownership of shares as a result of after-tax dollars invested, as well as by investing in employer shares in non-qualified deferred compensation and qualified retirement plans. This is an opportunity that should not be overlooked by executives.

Investing pre-tax dollars in employer shares reduces one's exposure by roughly 35%. That is, since the executive will pay ordinary income tax on all funds withdrawn from the plan, the government is effectively bearing 35% of the downside risk in the event that share price declines. Oftentimes, such pre-tax plans preclude the participant from reallocating balances invested in employer shares to other investment alternatives prior to retirement. As such, this is a long-term commitment. Nevertheless, the downside protection that comes with investing pre-tax dollars is an attractive incentive for utilizing these funds to satisfy share ownership requirements.

The real "trade-off" for this downside protection is, once again, tax related. All appreciation in shares held by a pre-tax plan will be taxed at ordinary income tax rates rather than the attractive long-term capital gain rates available if the shares were held directly. However, even if the overall after-tax rate of return were to be somewhat less than had the shares been owned outright, the diversification and downside protection benefit of having the government bear a significant portion of the risk of the associated investment is worthwhile. As such, restricted stock plans whereby an executive may elect to receive vested restricted stock units which are payable in the future, rather than receiving actual shares upon vesting, should be considered where these units are counted to meet stock ownership requirements.

Executive Stock Options

Thus far, we have addressed strategies with regard to stock grants. As discussed, stock grants are taxable upon vesting and would require liquification of shares in order to fund such income tax liability. Stock options, by contrast, are generally not taxable upon grant.

Inherent in the stock option are two components of leverage: financial leverage and tax leverage. Typically, options are granted with an exercise price that is equal to the current market value of the shares. As such, when shares appreciate, the executive has the benefit of growth on the full number of option shares, but does not have an "out of pocket" investment or tax cost associated with such shares. It is as if he has received an interest-free, non-recourse loan to purchase a given number of shares. This is what is meant when we speak of financial leverage.

Tax leverage results when the share price has appreciated but the gain remains unrealized and the tax deferred; i.e., no income tax cost has yet been triggered. Ordinary income tax is only realized upon exercise of the option and the ordinary income that is taxed is derived by subtracting the exercise price from the share price upon exercise. Obviously, with both kinds of leverage at work, executive stock options are a powerful wealth-building tool in a rising market.

Where an executive receives stock option grants on an annual basis, the more mature options may have significant appreciation. This value may be a material part of the executive's net worth. Looking at the downside, the erosion of share price will rapidly impair option value much the same as the leverage helped boost option value in a rising share price environment. For example, consider 1,000 option shares with an exercise price of $20 per share. If the share price is $100, the "in-the-money" pre-tax value of the options is $80,000. If the share price were to decline to $75—a 25% decrease—the in-the-money value of the options would decline to $55,000—a 32% decline.

Consequently, it is essential that option value be considered as part of overall diversification of an executive's wealth. However, because the in-the-money value of stock options is a pre-tax asset, the government is again bearing 35% of the (leveraged) downside that would result from a decline in share price. Diversification must properly be viewed as part of total portfolio strategy in which the executive should be mindful of his overall personal financial situation, trends in financial markets, and the historical performance and future outlook for his company as compared to alternative investments. Where an option has a sufficiently long exercise horizon prior to expiration, significant inherent financial leverage, and has a substantial in-the-money value, the combined leverage is a meaningful benefit that should not be discarded lightly.

If the executive were to exercise such options and pay the tax, his net after-tax proceeds would be available for alternative (presumably more diversified) investment. However, the retention of the options may result in a net overall after-tax rate of return which is higher than would be realized in alternative equity securities, even if the share price of the employer company should not keep pace with the rate of growth which would have been realized in an alternative investment. This rate of growth differential may be significant and still the retention of the options produces a greater level of return. This phenomenon illustrates the risk mitigating effect (as regards relative market performance on the upside) of the options' inherent leverage.

There is no simple "formula" for addressing the issues raised in this article, and "one size" most assuredly does not fit all—the right approach will differ based upon the particular circumstances of different individuals. However, it would be the rare executive who could prudently ignore the concerns we have discussed. In the final analysis, it is—as always—about balancing risk and reward while navigating the complexities of equity based compensation.

KLS Professional Advisors Group is a firm of wealth management experts committed to building effective long-term relationships based upon trust. We offer advice and counsel on every aspect of each client's financial affairs in pursuit of strategies designed to preserve and build their family's wealth. For further information about KLS, please contact Carlton B. Klapper, Managing Director, at (212) 355-0346, or e-mail us at gpangle@klsadvisors.com.