

Equity Compensation Planning: A Practitioner's Guide To A Lucrative Minefield

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“Equity Compensation Planning” is a *very* hot area. In recent years, corporations have been making increasing use of stock option plans, ESOPs, restricted stock, stock appreciation rights, “phantom stock”, and “performance shares”. Clients having access to such plans *need help*, and many advisors are considering adding advice about these assets to their practices. Certainly, this is a lucrative opportunity for those willing and able to practice in this field. But it's also a *minefield* for advisors who do not have the resources to do so competently.

It's a *very* complicated area, involving many variables that interact in complex ways. The impact of decisions as to exercise and management of these unusual assets upon the client's overall financial plan can be profound and, often, quite unexpected. Profitable strategies are often not at all intuitive, and are always extremely “case sensitive”. To practice such planning successfully, an advisor must have a firm grasp of the financial and tax aspects, skill in making complex concepts and relationships clear to the client, and access to, and understanding of, the tools necessary to model alternative strategies under various assumptions. It's not a field for amateurs, or for professionals unwilling to devote considerable time and effort to understanding it.

Fortunately, there are excellent resources available.

KNOWLEDGE

www.mystockoptions.com. This is a subscription-based web site, providing a large library of articles, FAQs, and information on all forms of equity compensation.

www.nceo.org. The National Center For Employee Ownership, offers an online course, *Equity Compensation Basics*.

www.nbcoa.com. The National Board of Certified Option Advisors offers an in depth certification program for advisors interested in specializing in equity compensation planning.

Stock Options: An Authoritative Guide to Incentive and Nonqualified Stock Options, by Robert R. Pastore, C.P.A. Written for the layperson in understandable, non-technical language – available at online bookstores, such as www.amazon.com.

Consider Your Options, by Kaye Thomas. An exceptionally clear treatment of qualified and non-qualified stock options, and an excellent choice for both the beginner and the more experienced practitioner. Available at online bookstores, such as www.amazon.com and at the author's wonderfully educational web site, www.fairmark.com.

TOOLS

Two of the best tools out there for advisors working with employee stock options are available from Net Worth Strategies, Inc., at www.networthstrategies.com.

StockOpter Insight® is not so much an *analytical* tool as a *relationship* tool. It enables advisors to build *ongoing* relationships with clients with employee stock options by helping them to understand, monitor, and manage opportunities and risks. A review, by this author, is available on www.networthstrategies.com.

StockOpter Pro®. This may be the “800 pound gorilla” of stock option planning software. This is an *intensively* analytical software program. Because it does such a good job of addressing the various

interactions that are involved in stock option planning, and the impact of changed assumptions upon overall results, the author will use **StockOpter Pro®** to illustrate the *practice management* and *client communication* issues that are so vitally important to working successfully in this area.

StockOpter Pro® is built upon the chassis of Microsoft® Excel®, and requires its installation on the user's computer. Special toolbars are created when the user invokes the *stockopter pro.xls* file (or any client file created in **StockOpter Pro®**) and saved under another name). It's an incredibly powerful program. It's also fairly demanding, so the more computer resources you have (both available memory and processor speed), the better.

Employee stock option planning, though very complicated, can be said to have three basic goals –

1. to maximize terminal wealth value (of options, employer stock, and the "investment account" to which cash flows from stock option activity are posted)
2. to achieve specific after-tax cash flow targets
3. to reduce the risk of over-concentration in a single stock, by diversification

(Some planners might consider a fourth goal – that of managing the client's exposure to Alternative Minimum Tax – but this author feels that this is really a subset of the second goal listed).

StockOpter Pro® allows the advisor to plan for all three goals interactively, in a fifteen-year (or shorter) time horizon. It does this by creating a set of *assumptions* and a *base case*, and allowing the user to modify those assumptions globally, and to create additional *cases* (each appearing as a separate worksheet, or tab, in the Excel® workbook). Each case can be modified extensively, as we will see.

The *Assumptions Tab* contains data about the client's income, deductions, tax estimates, the issuing corporations¹ (including stock price, dividend, and growth assumptions for each), and the investment account, to which cash inflows and outflows from stock option activity are posted (including rates of return for annual dividends, capital gains distributions, appreciation, and negative (loan) rate for negative balances). This information may be entered directly or by use of the *Assumptions Wizard*. These assumptions are used in every case sheet, but may be modified either by numeric entries or formulas.

The *Base Case* sheet is created automatically upon completion of the *Assumptions* sheet. Information on stock option and restricted stock grants is entered either directly into that sheet or by use of input *Wizards*. (The author recommends the latter method). Strategies may be modeled in this *Base Case* or in newly created case sheets. (The author prefers to leave the *Base Case* as is, titled in cell A1 as "Do Nothing", to illustrate the impact of allowing grants to expire and restricted stock to vest with no sales or 83(b) elections).

Strategies can be illustrated by manually entering exercise and sell information for each grant directly into the case sheets, or by use of the *Strategy Wizard*. This very handy feature offers four choices:

1. *By Grant Type* – Lets the user apply standard strategies, such as *Exercise As Late As Possible and Sell To Cover*, *Exercise As Soon As Possible and Hold Forever*, etc.) for all grants of a particular type (nonqualified, qualified, or restricted stock).
2. *By Inventory* – The user may sell $x\%$ of the available inventory, only if the market price is n times the exercise price.
3. *By Goal* – The user may employ either of two goal-based strategies:

¹ The newest version permits modeling of options and restricted stock from more than one corporation.

- a. To produce a given after-tax cash flow (either fixed or varying each year) from stock option activity
- b. To *diversify* into the *Investment Account*, by selling sufficient options and restricted stock to make exposure to the employer's stock equal to a targeted percentage of total portfolio value each year

The *By Goal* tab also includes a checkbox to “Exercise ISOs to AMT limit afterwards”

4. *AMT Limit* - This wizard will do a qualified exercise of ISO options until Tentative Minimum Tax equals Regular Income Tax in the year chosen.

As handy as the Wizards are, they don't “do the planning”. For one thing, they operate on *all* grants of the chosen type. For another, they don't pay attention to cash flow (unless you've chosen the cash flow option). It's essential that the user examine the impact upon cash flow of the strategies chosen, as well as the impact upon taxes and portfolio diversification. This is easily done, as the case sheets include extensive year-by-year details of both cash flow and tax results and a line for *Diversification Percentage*. (The user may choose to view all spreadsheet lines or condensed views for each sheet).

Every strategy (whether implemented manually or via a Wizard) involves trade-offs among Terminal Wealth, After-Tax Cash Flow, and Diversification. In stock option planning, as in military strategy, the Primary Principle is that of *The Objective*. If the client's primary concern is in maximizing terminal wealth, AMT liability or net cash outflow in intervening years *may* not be of great importance, but few clients are likely to hold to that objective no matter how much borrowing may be required to pay taxes due each year (and the interest on prior loans). Similarly, a rigid insistence upon minimizing AMT liability could result in lost growth opportunities or an overly concentrated portfolio. *StockOpter Pro®* is a very powerful analytical tool, but if the advisor and client do not have a good idea of the main objective, and the extent to which variance in accomplishing other goals will be tolerated, the result could very easily be “analysis paralysis”.

Perhaps the strongest feature of *StockOpter Pro®* is its ability to answer “What if?” *All* results are dependent on the assumptions made. By modifying assumed income, deductions, expenses, and the like, the user can test the impact of such changes upon overall results. The most important assumption – the prime affecter of the results – is, of course, the assumptions about the future price of the employer's stock. Many clients, who are often senior executives of the stock issuer, have considerable faith that their stock will grow substantially. This may be perfectly understandable, but an *assumption* to that effect could be financially perilous. Moreover, it can mask the very efficacy of certain strategies. Diversification, for example, is an important element in Risk Management, but, practically speaking, it's a moot issue if one assumes that her stock options and restricted stock will all grow at, say, 10% per year.

A worthwhile stock options strategy analysis *must* include projections of potential results if the employer's stock *does not* perform as the client hopes. Anything less is simply enabled wishful thinking. *StockOpter Pro®* makes such projections very easy. The user may manually change the assumed future stock price in *Assumptions* or use the wonderful *Stock Indexer*. This Wizard will change the employer's stock price over future years in any case sheet to mirror a chosen index, which may be actual indices (such as the S&P500 or DJIA) or any of several dozen publicly traded stocks in *StockOpter Pro®*'s database. The user may even choose the index starting year. Thus, the advisor might say to the client “We've examined several strategies using your assumed growth rate of 5% per year for your company's stock. But, as you know, it might not perform like that. We can look at those same strategies assuming that it will act, over the next 15 years, like one of *these* stocks or stock indices. Which one would you like to model first?”

When future cash flows and portfolio values are projected using both optimistic assumptions and pessimistic ones – especially when stock prices aren't assumed to be constantly growing or declining - the relative profitability – and *riskiness* - of the strategies chosen is much clearer. The client is able to measure what he might gain *and* what he might lose.

This insight is something most clients having “equity compensation” need and want. And the advisor who is able to provide it will find her efforts well rewarded. But, as we’ve noted, this is a very complex area, and demands considerable skills and knowledge and good tools. *StockOpter Pro®* is a very good tool. But it will not make a competent “stock option planner” out of a beginner. The author strongly urges anyone entering this field of planning to acquire a sound understanding of the basics, including the often-bewildering tax treatments involved, before offering advice about equity compensation issues.

The sources listed above are all excellent. Net Worth Strategies offers consulting services, both to licensees of its software and other advisors, as well as a first-rate workshop for *StockOpter Pro®* users. The author attended one such workshop, and was well satisfied. Your professional society probably includes members experienced in the field who will agree to work with you. Getting help just makes good sense.

“Equity Compensation Planning” is, at the present time, a relatively small part of the overall financial planning landscape. It is, however, a field that is likely to become increasingly more important – especially as the values of stock options currently “under water” increase. Clients holding such options will demand competent advice and will be prepared to pay for it. Advisors meeting this demand will find their efforts well rewarded. But, lucrative as this field is and will continue to be, for qualified advisors, it will remain a minefield for those who lack the knowledge, skills, and tools to provide competent counsel.

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