SAVANT WEALTH MANAGEMENT EST 1986

# THE GREAT DRAWDOWN

*Optimizing Stock-Based Compensation for Planned and Unplanned Retirement*

Wise Counsel

Retirement is the long-awaited culmination of a corporate career. Over your lifetime, your corporate career can include milestones, promotions, and assignments in distant cities. As an executive, you contribute to team triumphs and experience solo setbacks. The drive and energy required is relentless and exhilarating. The closer you rise to the top, the harder it is to stay there. At some point, whether the timing is right, health and wellness issues intervene, or something more compelling outweighs continuing the pace on the corporate treadmill, retirement becomes the next step.

## BRIDGING THE GAP

The financial considerations of retirement span a variety of topics: the sufficiency of assets, your retirement age, the mix and age of corporate benefit plans, and your lifestyle and income requirements. When you plan for retirement at age 55-65, you often expect savings to bridge the income gap until you become eligible to receive pensions and Social Security. Savings can bridge the gap 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, you may need to rework the plan to cover a broader gap before reaching the qualifying age to receive pensions and Social Security. The complexity surrounding stock-based compensation clouds the dilemma: Which funds should be drawn first to optimize performance and minimize the tax consequences? This paper discusses how we go about sequencing cash flows to cover living expenses in retirement.

# Planned vs. Unplanned Retirement

Events like job insecurity or a health issue can cause even the most carefully constructed retirement timeline to go awry.

Keith, 57, qualified for retirement two years ago, after 25 years with the company. Since the birth of their third grandchild, his wife, Penny, has wanted 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 four months, Social Security, although not substantial, will become 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 think about how all 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 to match them with income. This can be accomplished through a spending plan, based on what you expect your household needs to be, versus what they have been historically. Typically, a good rule of thumb spending target should equal about two-thirds or three-quarters of pre-retirement spending. Based on your age and the number of years before you can tap into pension and Social Security, you have quantified the retirement gap.

You can track expenses in many ways, including a simple spreadsheet or programs like Quicken. By gathering bank statements, spreadsheets, or other budgeting software reports, your advisor can help you develop a template to help you quantify your expense picture. This new phase of life could be a good time to begin using an electronic template to track your spending and benchmark your actual income and expenses.

## 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 create an estimate of your household expenses. We usually target an amount of two-thirds 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? Paying off loans and mortgages before your retirement date can provide peace of mind. 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 a 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

Your financial advisor can assist you in developing a spending plan and quantifying the top categories of your spending. Whether you use a software program 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.

**This is intended for illustrative purposes only and is not representative of actual clients or results.*

# Rules of Thumb in Accessing Income from Savings and Retirement Assets

## Best and Worst Sources of Funds: Taxes Matter

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 a 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 72 (or 70-1/2 if you were born before 7/1/1949), 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 1/2 - 1%, funds invested in assets subject to capital gains tax, and 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, your advisor can 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 an example of an asset that looks similar but is handled quite differently, depending on the type of compensation, the type of account in which it is 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 is 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 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 NQO 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 the grant date and not the 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 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 (PSUs) 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 (SARs) 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 in cash, but it could be paid in shares.

## Other Company Stock

Employee Stock Purchase Plans (ESPPs) are employer-sponsored plans that allow eligible employees to buy stock periodically 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 for evaluating each compensation type for source of funds include:

**Economic –** There are economic considerations unique to each form of compensation. In the case of options, for example, consider when the fair value of an option has been realized. How much 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 –** Are there other reasons to hold company stock, such as optics or dividend income? To meet any trading concerns, you may need 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 lets you trade company shares, including stock options, while avoiding insider trading liability.

Each executive must balance a different set of variables. Considerations distinct to each type of compensation may make it appropriate to tap one form before other forms of compensation. This educational 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 recommendations based on your stock-based compensation.

Now that we have covered stock-based compensation, it's time to scrutinize and evaluate other income sources you may have considered. Salespeople often approach executives with a pitch for annuities, but annuitization may not be optimal for most people.

# Annuities: Why Give Up Control of Your Assets?

Many people are attracted to the story they hear 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 to receive a "guarantee" of income.

Annuities are among the most expensive investment types because you pay for the insurance and 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 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 may be 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 keep pace with inflation;
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. 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) may benefit from deferring to age 70 to maximize their benefit. Examining the projections for both spouses can help maximize income over time.

Depending on your income, you can expect your Social Security benefit 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, 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

Today, few companies 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 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 they follow a pension-maximization strategy. If you find yourself in this situation, 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 57 and plans to choose 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 covering joint and survivor. This means after he dies, Marge would receive 100% of his benefit.

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

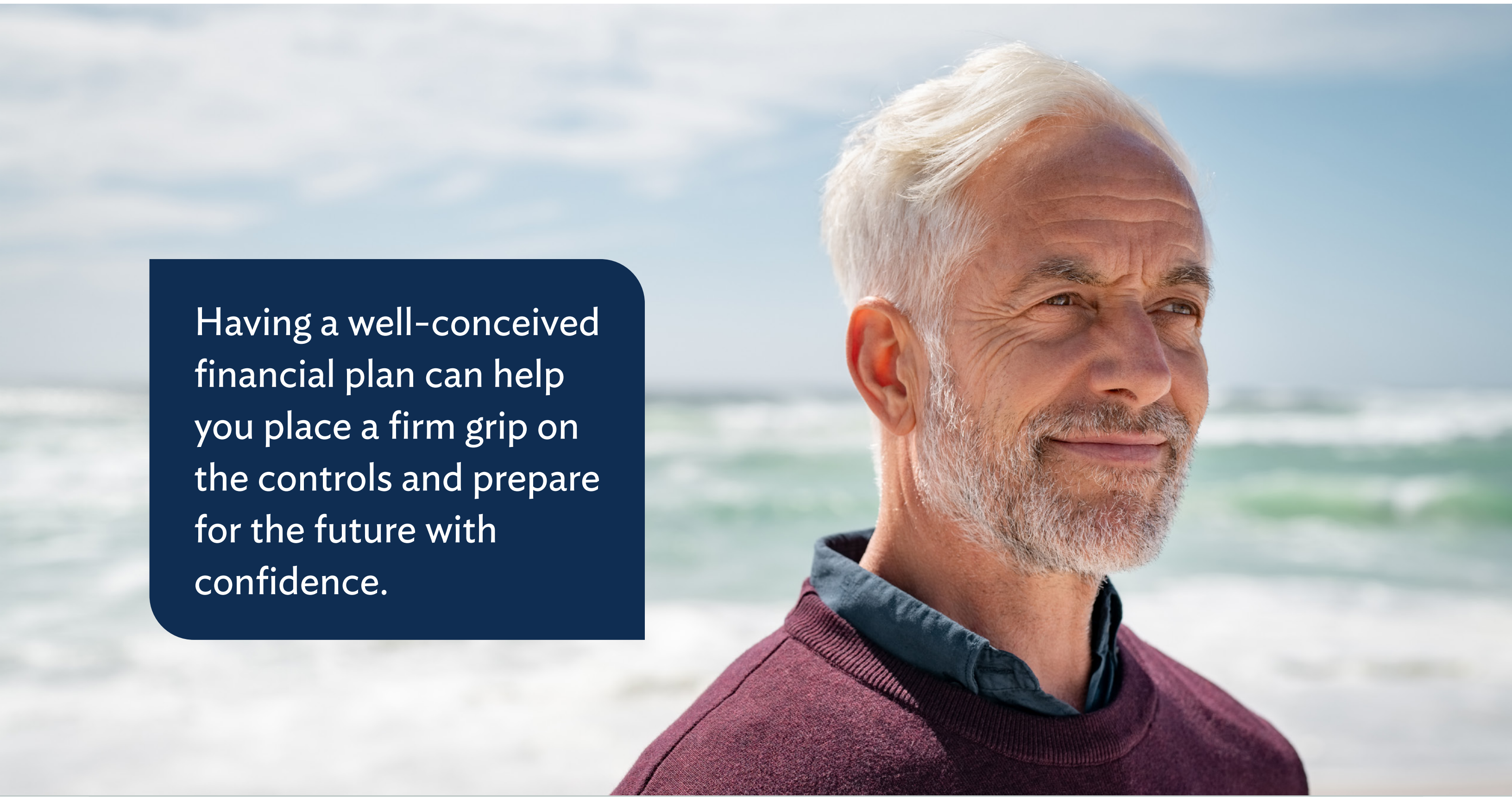
Or, he can pair the higher pension amount ($8,000) with a private insurance policy offering a monthly benefit to Marge of $8,000 per month in the event of his death. This would make sense if the premium costs less than $1,500 per month. If his non-working spouse dies first, he could cancel the policy 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 second person's death.* The goal should be to find the right solution to benefit both spouses in a cost-effective way.

## Summary

When it comes to managing stock-based compensation, your advisor strives to apply specialized insight with concentrated stock positions that are subject to complex tax and regulatory considerations. The process to meet income needs in retirement incorporates compensation, tax, and income and estate planning 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) accounts and IRAs, 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.

*Sources: The Stock Options Book, 23rd Edition; Selected Issues in Equity Compensation, 19th Edition.*
**This is intended for illustrative purposes only and is not representative of actual clients or results.*



# About Savant Wealth Management

Savant Wealth Management is a leading independent, fee-only firm that has been serving clients for more than 30 years.  Since inception, we have been committed to one key principle: all financial advice should be offered in the best interest of the client. We offer our clients wise counsel to help them pursue their financial goals.

As a trusted advisor, Savant offers investment management, financial planning, tax and consulting, retirement plan, and family office services to financially established individuals and institutions.