A close-up photograph of a woman with black-rimmed glasses balancing a stack of wooden blocks on a table. She is looking intently at the blocks, with her hand near the top of the stack. The background is blurred, showing an outdoor setting with greenery.

SEPTEMBER 2020

Kitces Monthly Webinar Workbook

NAVIGATING THE COMPLEXITIES OF EQUITY BASED COMPENSATION FOR CORPORATE EXECUTIVES

PRESENTED BY

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P I M C O



A Little About...

JOHN NERSESIAN

John is head of advisor education at PIMCO, where he provides advanced wealth management and investment consulting education to financial professionals. In addition, he is a faculty member for the IWI Certified Private Wealth Advisor (CPWA) and Certified Investment Management Analyst (CIMA) education programs held at Yale University and The University of Chicago.

Prior to his current roles, John was also:

- Senior Managing Director of wealth management services for Nuveen Investments
- The first vice president at Merrill Lynch Private Client Group, where he also led advanced training for financial consultants
- A board member of the Investments and Wealth Institute (IWI, formerly IMCA) from 2006–2017 and as chairman for the 2014–2015 term

He has 35 years of investment and financial services experience and holds an undergraduate degree in business and economics from Lehigh University.

ABOUT THE WEBINAR

Executive compensation is an important and complex topic that can be financially confusing and emotionally draining for both clients and advisors.

In this educational webinar, John Nersesian discusses executive compensation plans, trends and common concerns as well as how advisors can maximize executive compensation planning strategies.



THE NEED FOR ADVICE

THE NEED FOR ADVICE



NOTES

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Company Constraints

- Imposed Lock-Ups
- Limited Trading Windows
- Company Mandates

Information Processing

- Infrequent Reporting
- Confusing Plan Documents
- Tax Ramifications

Investor Challenges

- Lack of Coordination
- Concentration Risk
- Procrastination
- Access to Qualified Advice

THE NEED FOR ADVICE

Behavioral Biases

Bias	Definition	Potential Effect of Executives
Overconfidence	The tendency to overestimate or exaggerate one's ability to successfully perform a given task	Because executives generally have access to greater inside knowledge of an individual firm, they tend to overrate their abilities and overvalue company holdings
Status Quo	Increased choices and information generally lead to greater indecision	The scientific principle of inertia : corporate executives often avoid making changes, instead selecting the option that keeps conditions the same
Home Country	The tendency to favor companies in one's own country over those from other regions and countries	With wealth heavily concentrated in company stock , executives may not realize their allocation could be negatively impacting portfolio diversification
Endowment	The tendency to give holdings that are owned a disproportionate value because they are already owned vs. purchasing outright	Executives may hold onto inappropriate assets that they otherwise would not buy (or own) if they didn't already hold them

NOTES

THE NEED FOR ADVICE

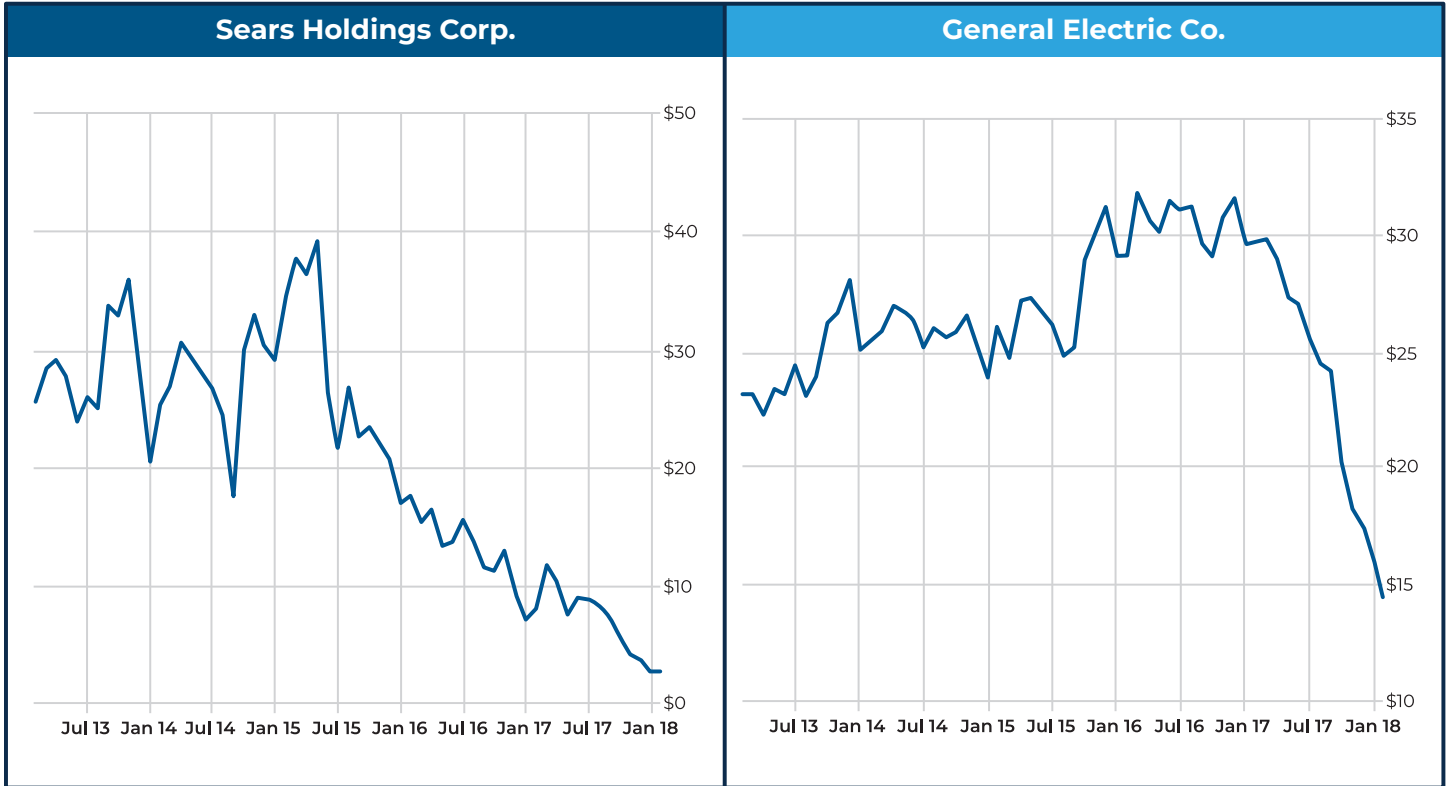
DISCOVERY QUESTIONS

- What is your primary objective for these assets (tax minimization, appreciation, risk reduction)?
- What will these assets be used for in your financial plan (retirement, business, charitable)?
- What is your view of your company stock – why?
- How do you see your role in your company changing?
- What is your view on the direction of tax rates?
- Describe your exit strategy for these positions?
- If you didn't work at your current company, how much of the stock would you own in your portfolio?
- What would be more disturbing: selling a security that continues to rise, or holding one that continues to fall?
- If you were presented with cash equal to the value of your current position, how much would you allocate to your company stock?



CONCENTRATION RISK

CONCENTRATION RISK



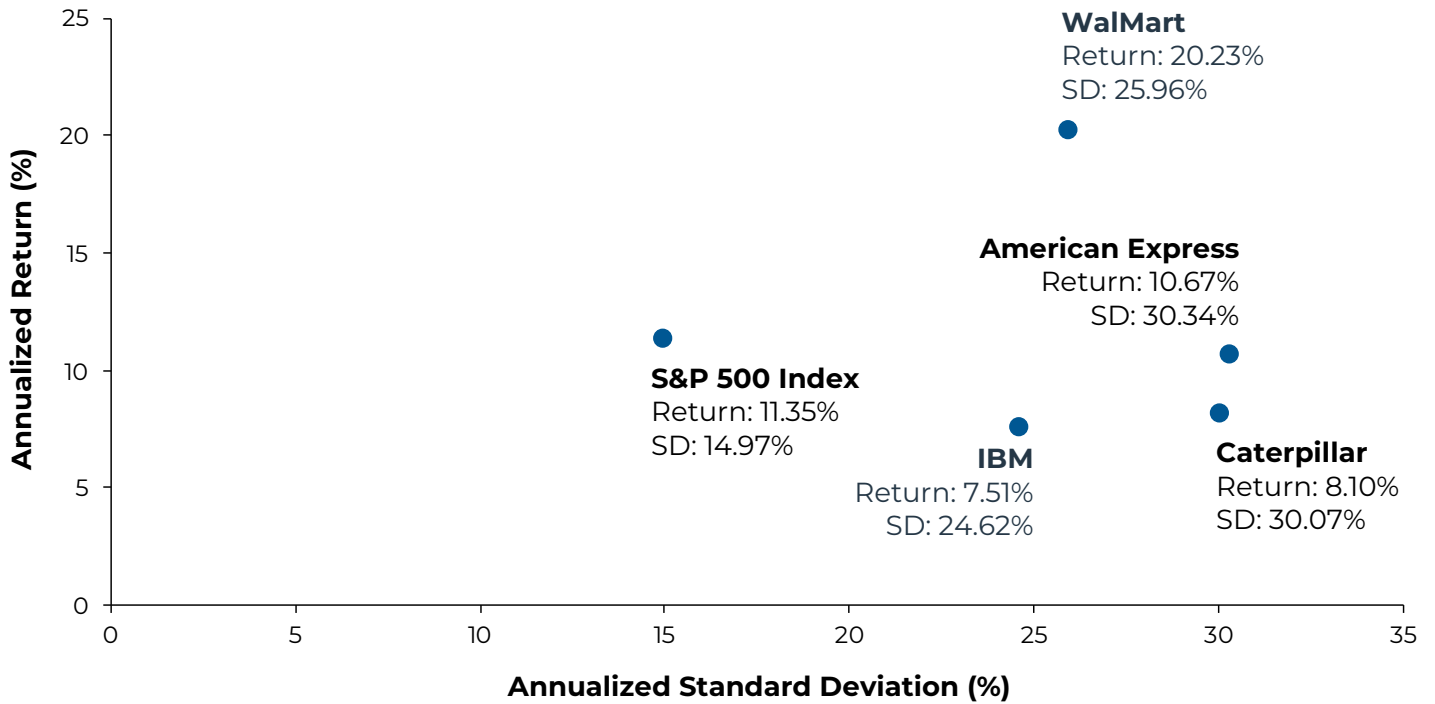
Sample for illustrative purposes only
 Source: wsj.com

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CONCENTRATION RISK

Standard Deviation S&P 500 Index vs. Individual Stock

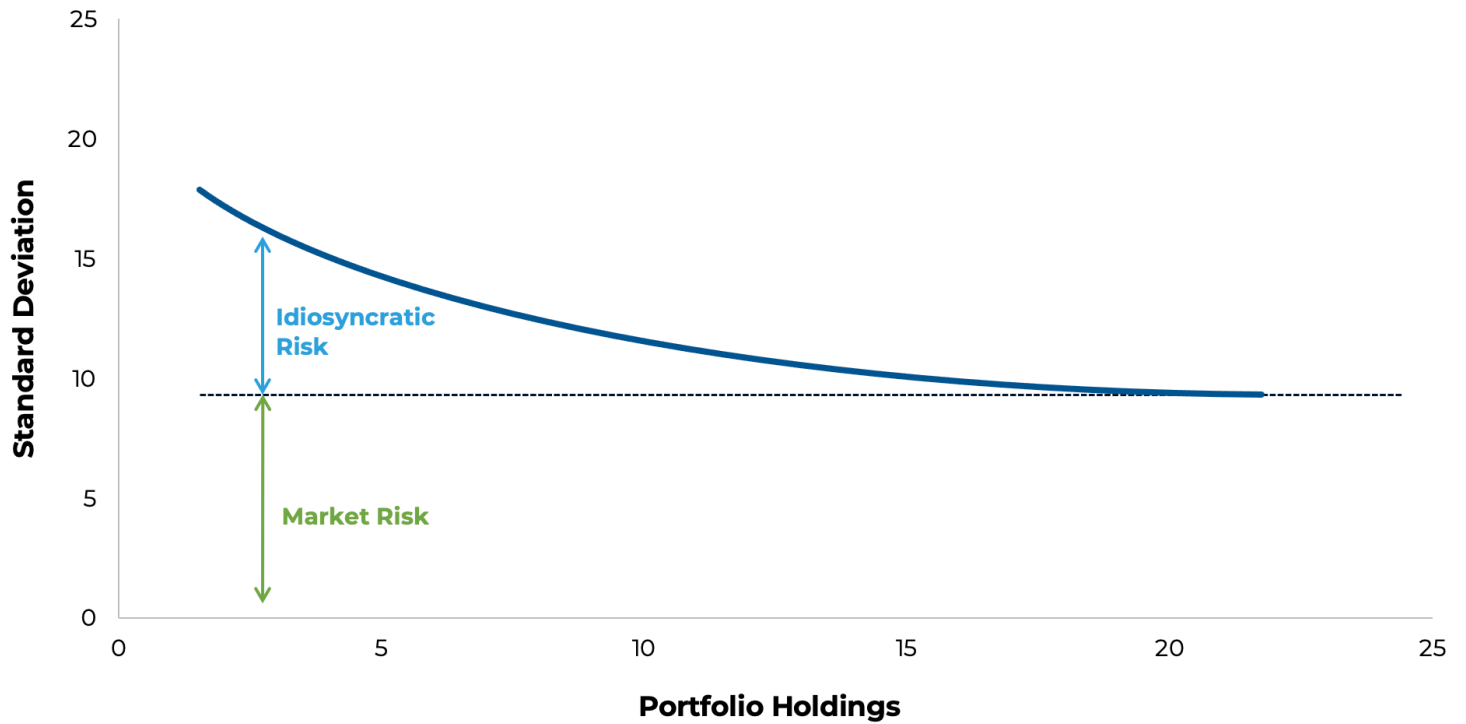


Sample for illustrative purposes only
 Source: Morningstar, Period: 1/1/1976–12/31/2015.

NOTES

MEASURING RISK

Components of Risk Diversification



Sample for illustrative purposes only

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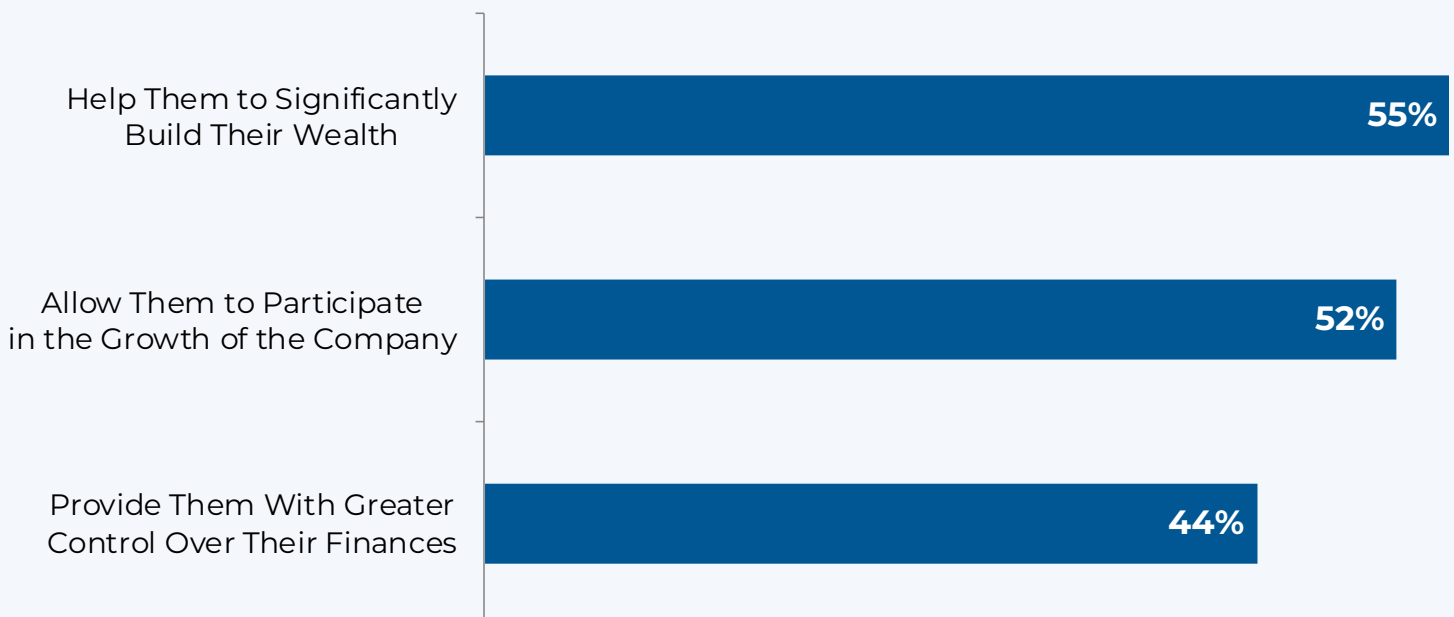
TRENDS IN EXECUTIVE COMPENSATION

EQUITY COMPENSATION IS HIGHLY VALUED

WHY COMPANIES ISSUE EQUITY COMPENSATION AWARDS

- Attract, retain, motivate high-value employees
- Reduce out-of-pocket compensation costs
- Link company performance to employee compensation
- Provide pride of ownership to employees

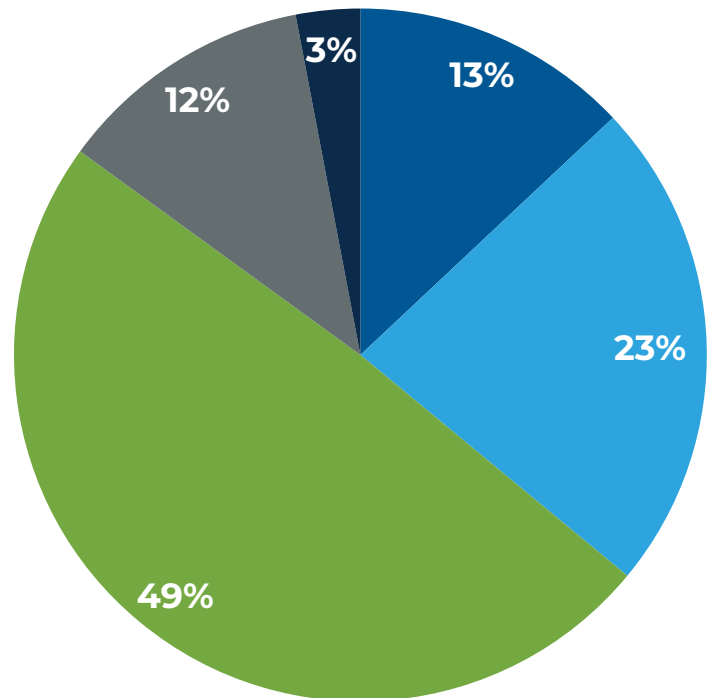
Top Reasons Why Plan Participants View Equity Compensation As An Essential Or Very Important Benefit:



CEO COMPENSATION PACKAGES

→ Dominated by incentive-based pay (bonus, stock, and options) whose ultimate value depends on performance

- Salary
- Bonus
- Stock
- Options
- Other

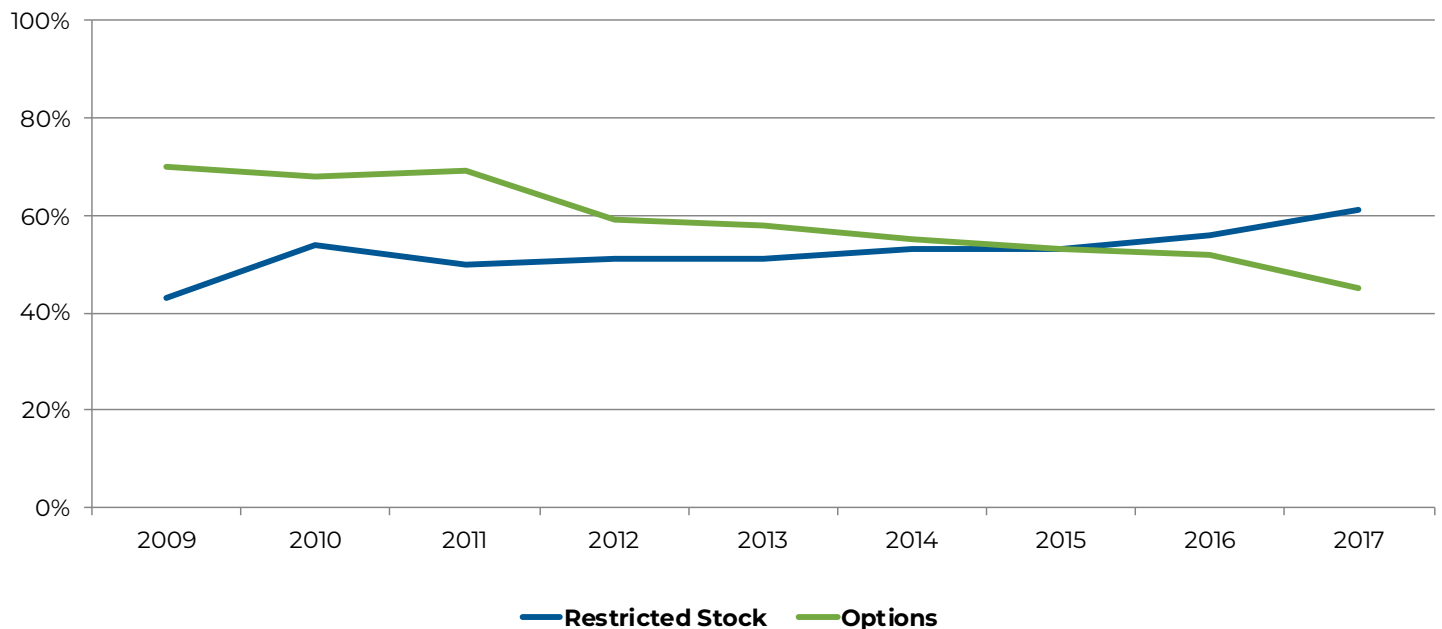


Source: Equilar, CEO Pay Trends (2017)
Sample includes CEO compensation of companies listed in the S&P 500 Index.

NOTES

COMPARING RESTRICTED STOCK VS. OPTIONS

→ In recent years, stock-based performance awards have replaced stock options as the most prevalent form of equity-based pay.



Source: Equilar, CEO Pay Trends (2018)
Sample includes CEO compensation of companies listed in the S&P 500 Index.

NOTES

COMPARING RESTRICTED STOCK VS. OPTIONS

Restricted Stock		ESOs
Time Performance Goals	Vesting	Time
No	Leverage	Yes
Yes	Intrinsic Value	No
Yes, when paid to shareholders	Dividends	No
Yes	Voting Rights	No
Vesting	Triggering Event	NSO: Exercise ISO: Sale of Stock
Ordinary Income	Tax Treatment	NSO: Ordinary Income ISO: LTCCG Potential
83(b) Election Option	Early Exercise	83(b) Election Option
At Vesting	Issuer Expense	At Exercise

NSO=Non-qualified stock option; ISO=Incentive stock option

Source: PIMCO. PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns. Refer to Appendix for additional tax information.

NOTES



EMPLOYEE STOCK OPTIONS (ESO)

TERMS AND CONCEPTS

TWO TYPES OF STOCK OPTIONS:

- 1 _____ (NSOs)
- 2 _____ (ISOs)

IMPORTANT DATES:

- 1 Grant Date:
- 2 Vesting Date:
- 3 Exercise Date:
- 4 Sale Date:
- 5 Expiration Date:



NSOs are granted more often. About 95% of options are of the NSO variety.

ADDITIONAL CONCEPTS:

Strike Price/Exercise Price:

Bargain Element:

In-the-Money/Out-the-Money:

Cashless Exercise:

Qualifying Disposition:

COMPARING TYPES OF OPTIONS

NSOs		ISOs
Employees, Directors, Consultants	Grant	Employees Only
Transferable	Transferability	Non-Transferable Except at Death
None	Grant Limit	\$100,000 Rule
Exercise	Triggering Event	Sale of Stock
Ordinary	Taxable Income	LTCG Potential
None	AMT Impact	Preference Item at Exercise

Source: PIMCO. PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns. Refer to Appendix for additional tax information.

NOTES

\$100,000 RULE EXAMPLE

4-Year Vesting Schedule

Year	2016 Grant \$120,000	2017 Grant \$160,000	2018 Grant \$200,000	Total
2017	\$30,000	-	-	\$30,000
2018	\$30,000	\$40,000	-	\$70,000
2019	\$30,000	\$40,000	\$50,000	\$120,000
2020	\$30,000	\$40,000	\$50,000	\$120,000
2021	-	\$40,000	\$50,000	\$90,000
2022	-	-	\$50,000	\$50,000

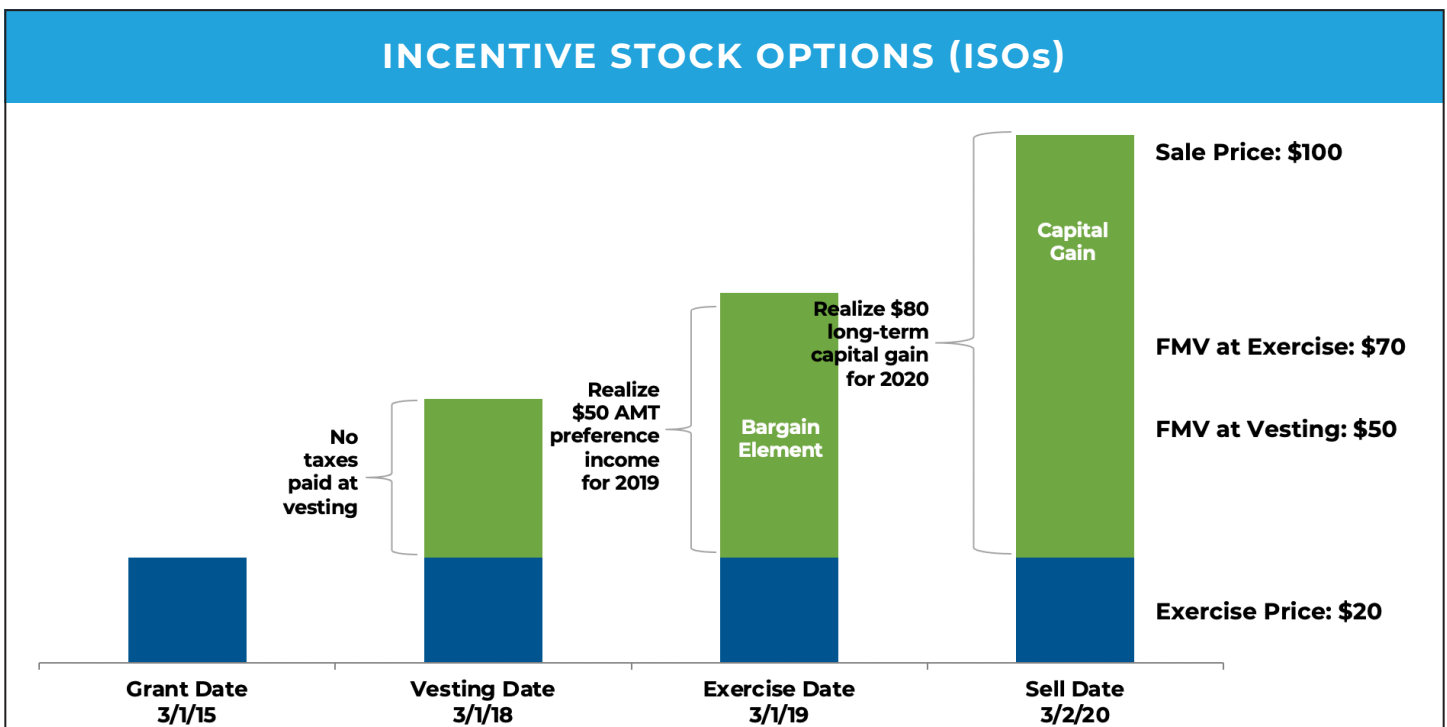
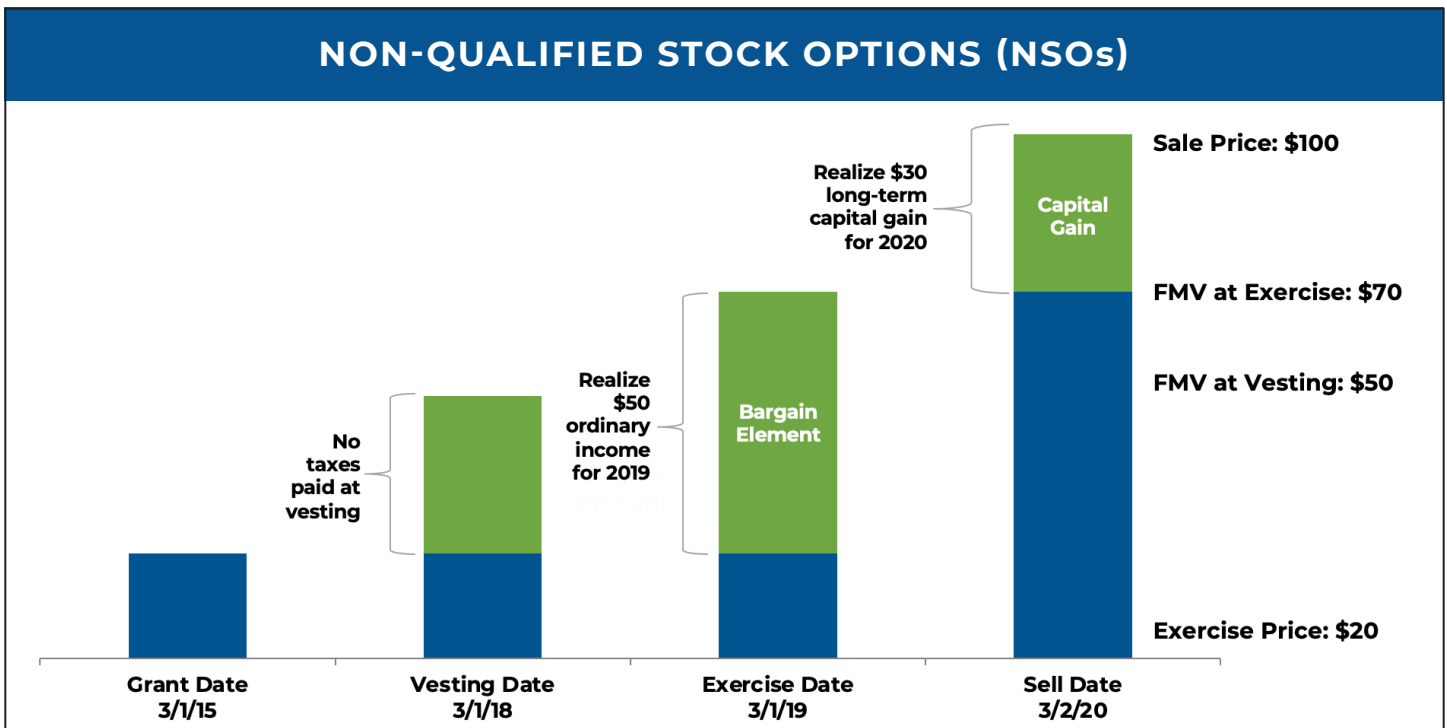
Hypothetical example for illustrative purposes only



\$100,000 RULE

The maximum number of options an employee can receive and treat as ISOs is limited to \$100,000, based on the price of the stock at the time of the award that become exercisable for the first time in a calendar year.

COMPARING NSOs AND ISOs



STRATEGIES TO HELP CLIENTS ACHIEVE OBJECTIVES



Consider strategies based on primary objectives.

Risk Reduction	<ul style="list-style-type: none"> • Exercise and Sell to Cover • Stock Swap
Liquidity	<ul style="list-style-type: none"> • Exercise and Sell to Cover • Tandem Exercise
Tax Minimization	<ul style="list-style-type: none"> • Exercise and Hold • Stock Swap • Section 83(b) Election • ISO Qualifying Disposition • ISO Tandem Exercise • Gifting • Charitable Lead Trust
Wealth Accumulation	<ul style="list-style-type: none"> • Delay – Continue to Hold • Stock Swap • Gifting to Family

NOTES

ISO QUALIFYING DISPOSITION

AMT BASICS

- Introduced in 1969 to ensure “fair” tax burden for all taxpayers
- Parallel calculation of tax liability (Form 6251)
- Taxpayer is responsible for paying the greater tax bill
- Includes larger range of income items, taxed at lower marginal rate
- Deductions for state taxes and property taxes are disallowed
- Dividends and LTCG taxed at same investment income rate
- Affected approx. 4.8 million taxpayers in 2017, but less likely going forward due to:
 1. Higher AMT exemption amount and phase-out levels increased
 2. State income and property tax cap
 3. Elimination of personal exemption and miscellaneous itemized deductions

NOTES

ISO QUALIFYING DISPOSITION

AMT –
KEY FIGURES

2020 Exemption and Phase-Out Amounts

Filing	Exemption	Phase-Out Range
Married Filing Jointly	\$113,400	\$1,036,800+
Married Filing Separately	\$56,700	\$518,400+
Single/Head of Household	\$72,900	\$518,400+

2020 Tax Brackets

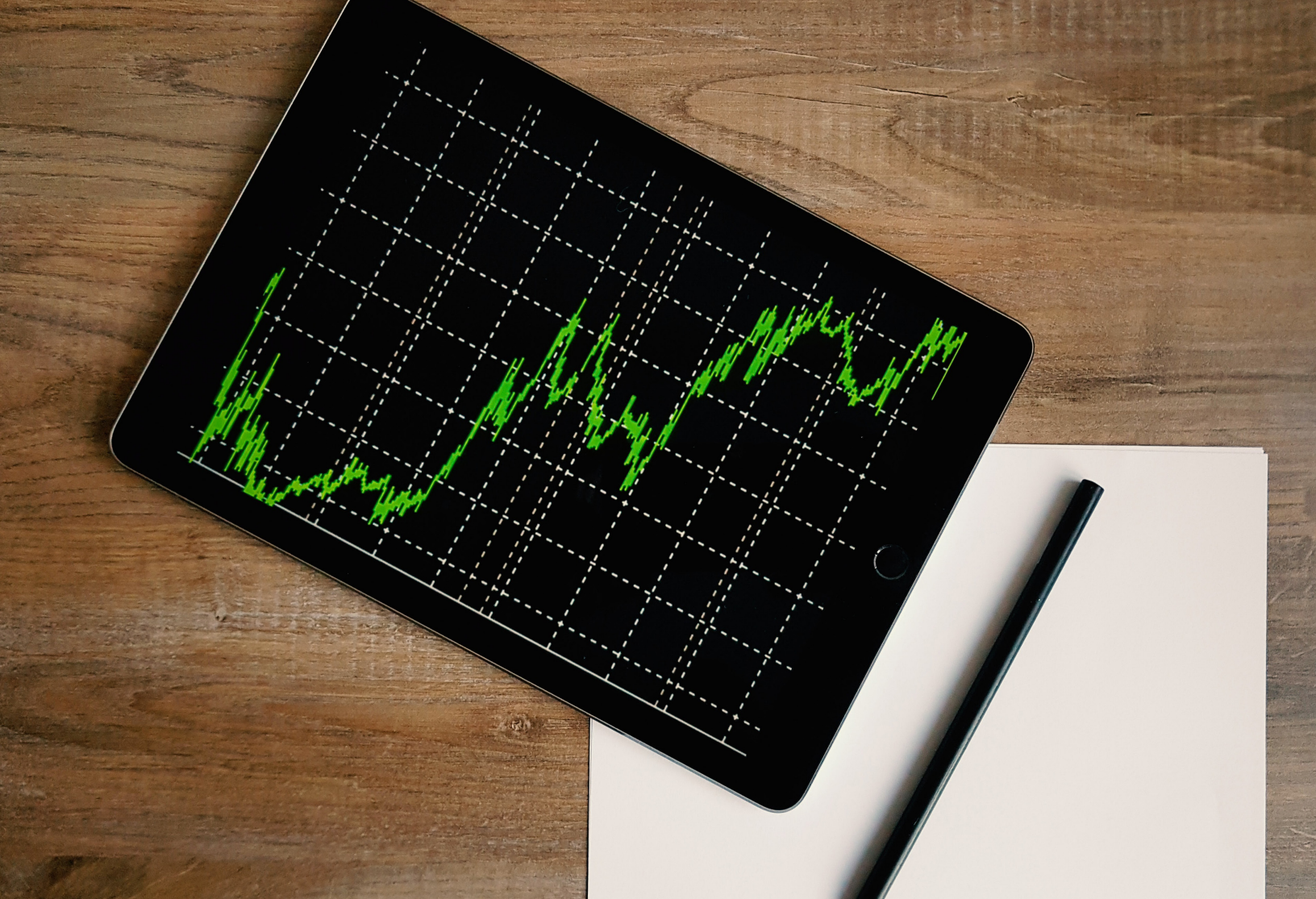
	Married Filing Separately	All Others
26%	\$0 - \$98,950	\$0 - \$197,900
28%	\$98,951+	\$197,901+

As of January 1, 2020

Source: IRS

Information provided is current as of the date specified and is subject to change without notice to you. Amounts, thresholds and ranges are subject to annual IRS inflation adjustments. Data was obtained from sources believed to be reliable but PIMCO does not guarantee the accuracy or completeness of the content provided. PIMCO undertakes no obligation to update the information and disclaims any warranties or fitness for a particular purpose. PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns. Refer to Appendix for additional tax information.

NOTES



RESTRICTED STOCK AND RSU GRANTS

RESTRICTED STOCK

ADVANTAGES

- Allows companies to attract, retain, and motivate key employees
- Connects company success with personal compensation
- Can carry dividend or voting rights
- Retains some value for employees even if price declines
- Capital gains treatment available on gain with 83(b) election
- Requires fewer shares to provide a similar level

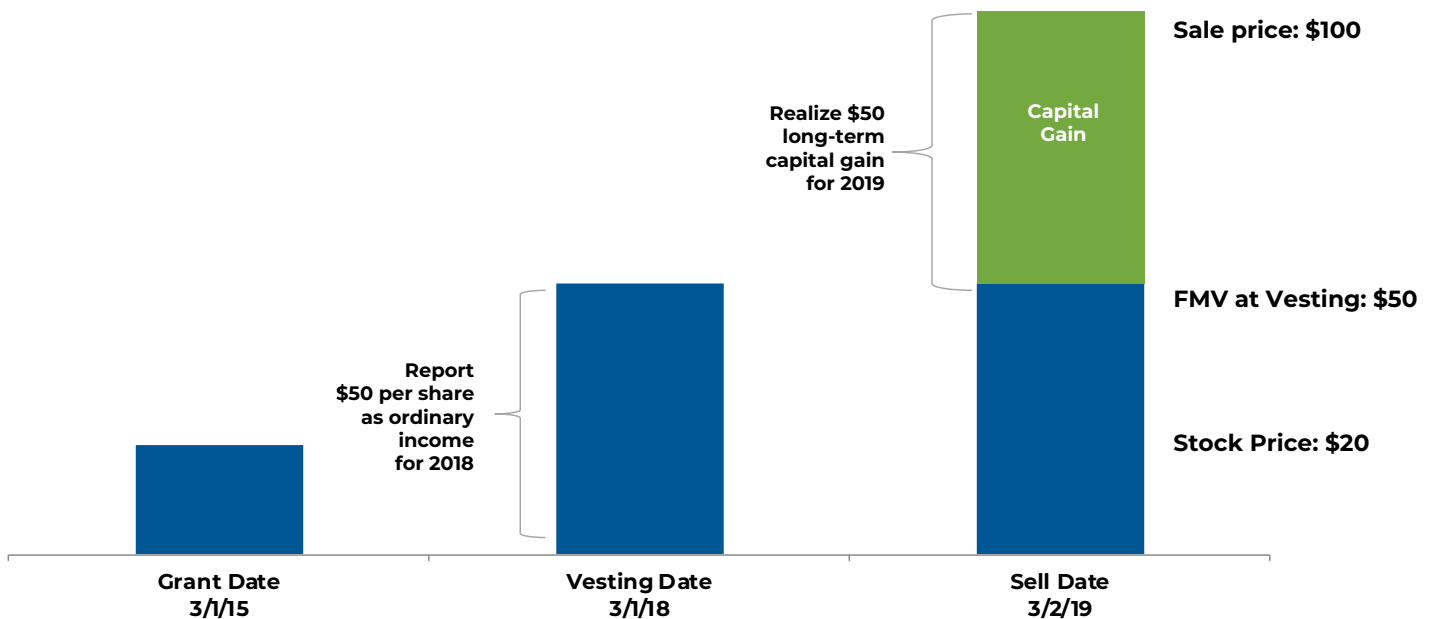
DISADVANTAGES

- Vesting restrictions can make benefit appear abstract to employees
- Company unable to take tax deduction for the value of the gain employees realize with 83(b) election
- Subject to variable accounting rules, requiring changes in value be charged as compensation expense
- New compensation deduction limit of \$1 million for top 5 earners including CEO and CFO

NOTES

COMPARING RESTRICTED STOCK VS. RSU GRANTS

Restricted Stock		RSUs
Employees, Directors, Consultants	Grant	Employees, Directors, Consultants
None	Grant Limit	None
Non-Transferable	Transferability	Non-Transferable
No Limit After Vesting	Term	No Limit After Shares Received at Vesting
Yes, taxed at ordinary rates until vested	Dividends	Optional, taxed at ordinary rates until vested
Yes	Voting Rights	No
At Vesting	Triggering Event	At Vesting
Ordinary	Taxable Income	Ordinary
83(b) Election Option	Early Exercise	Not Eligible



Hypothetical example for illustrative purposes only
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MATRIX OF POTENTIAL SOLUTIONS

Liquidity	<ul style="list-style-type: none"> • Restricted Stock Sale • Writing OTC Covered Call • Variable Prepaid Forward • Loan
Hedging	<ul style="list-style-type: none"> • Purchase OTC Put Option • Zero Premium Collar
Diversification	<ul style="list-style-type: none"> • Exchange Fund • Variable Prepaid Forward • Purpose Loan
Wealth Transfer	<ul style="list-style-type: none"> • Gifting to Family • Donor Advised Fund (DAF) • Charitable Remainder/Lead Trusts • Family Foundation
Tax Minimization	<ul style="list-style-type: none"> • 83(b) Plan

NOTES



OTHER EXECUTIVE COMPENSATION PLANS

NON-QUALIFIED DEFERRED COMPENSATION (NQDC) – 409A PLANS

- Qualified DC plans allow the employee to defer current compensation and taxes to be withdrawn and taxed at a later date, subject to IRS limits
- NQDC arrangements allow highly compensated employees to defer additional amounts above the IRS limits
- Irrevocable elections for deferral amount and distribution must be made in year prior to compensation earned
- Benefits: deferred compounding on a larger (pre-tax) amount; tax rate arbitrage
- Plans are not subject to qualified DC requirements: fiduciary, IRS filing, nondiscrimination, funding, vesting, reporting, etc.
- Plans do not receive ERISA protection - unsecured loan subject to bankruptcy
- Investment options often similar to 401(k) menu
- Rollover option not available, but distributions not subject to RMD at age 72
- Triggering events: fixed date, retirement, change in control, disability, death

NOTES

EMPLOYEE STOCK PURCHASE PLANS – ESPPS

- Opportunity for employees to purchase company shares at discounted price through ongoing payroll deductions
- Many plans offer discount of 15% using “look back” provision: the lesser of the offering date or the purchase date
- Voluntary participation, but often limited based on employment duration
- IRS cap of \$25,000 per calendar year

NOTES

ADDITIONAL CONSIDERATIONS AND RESOURCES

Attracting the C-Suite: Keys to Success



Build your competency in this area



Provide CE offerings to CPAs, attorneys, HR officers



Identify key advocates at local companies



Use public filings to identify potential clients



Read the plan agreements to develop company expertise

Resources

- *The Executive Compensation Handbook*, Kristi Anderson
- *The Complete Guide to Executive Compensation*, Bruce Ellig
- *Managing Concentrated Stock Wealth*, Tim Kochis
- *Consider Your Options*, Kaye Thomas
- *The Complete Guide to Employee Stock Options*, Frederick Lipman
- [Pimco.com/advisoreducation](https://pimco.com/advisoreducation)
- nceo.org
- mystockoptions.com



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