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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- The Federal Accounting Standards Board (FASB) announced that it will issue rules this year mandating the expensing of employee stock options, most likely effective in early 2005.
- Of 40 million Medicare beneficiaries, one third have no prescription drug coverage once outside the hospital.

Restricted Stock as a Compensation Tool

Restricted stock is coming to a company near you. It is a nonqualified compensation arrangement that offers both executives and employees a stake in the company without the high volatility of option values. Last year Microsoft announced that its employees would henceforth receive restricted stock units in lieu of stock options. Amazon, Altria, and Progressive Corp have similarly begun to issue restricted stock to rank and file employees. More than 60% of companies surveyed by Mercer Human Resource Consulting in April 2003 said they were either introducing restricted stock or expanding their current program. There is a sea change in compensation afoot … and much to learn about it.

Stock market declines since 2000 have left many stock option programs under water. As much as 50% of outstanding stock options would have no value if exercised today. If recent trends continue, there is a good chance that your employer may substitute restricted stock for stock options. According to the consulting firm Watson Wyatt, restricted stock grants are generally made to employees earning $80,000 or more.

Why now? Apart from the decline in technology stock values, regulators have been pressuring companies to immediately expense options. Companies need not recognize restricted stock expenses until they vest with the employee. Also, many of yesterday's high flying tech companies have grown up. Microsoft is a cash cow that has been a public company for 20 years. Restricted stock offers its more mature work force a stake in the firm that will always be worth something as long as the company is around.

Corporate scandals have also called into question the incentives offered by stock options. They can increase dramatically in value with relatively small changes in share price. Executives laden with stock options might be tempted to make decisions designed to enhance short-term stock price appreciation at the expense of the long term health of the company.

So how does restricted stock work? Restricted stock effectively mimics that value of publicly traded stock. The key difference is that there are limits as to its disposition. It typically cannot be sold or pledged prior to vesting. There is usually a graduated vesting schedule that must be satisfied before the employee is able to sell shares. For higher level executives, performance criteria must be met in order to release restricted stock. These vesting schedules resemble those in place for stock options. Many plans provide for accelerated vesting in the event of death. In that case, the value of restricted stock becomes income with respect of the decedent (IRD) and is included in the employee's estate.

Even before restricted stock vests, the employee receives ongoing dividends. The employee has less flexibility as to tax liability compared with stock options. Ordinary income tax is recognized on the value of restricted stock as it is released to the employee. Payroll taxes are also due during the tax year in which restrictions lapse. Tax liability can be delayed if *restricted stock units* are issued in lieu of the stock itself. The former is a contractual promise to issue shares at some future date after they are vested. Employees with restricted stock units

Restricted Stock (continued)

receive dividends and enjoy voting rights. Microsoft uses restricted-stock units.

Most restricted stock plans impose barriers on the transfer of restricted stock even after shares vest. Often employers request that their employees hold on to stock. The SEC may prohibit employees considered insiders from selling within 30 days of an earnings announcement. Remember …the employee owes taxes on the value of vested stock regardless of his ability to dispose of it. That creates a potential liquidity problem. Employees should set aside cash in advance of major vesting events so that they can afford the tax liability.

Another stratagem available to the employee is an election under section 83(b) of the Internal Revenue Code to pay taxes on the fair market value of the stock within 30 days of the grant. Thereafter, no income taxes are due on the stock when its restrictions lapse. However, appreciation on the stock once it is sold is taxed at the long term capital gains rate. Such an election is fraught with peril in that subsequent deductions may not be taken in the event that the stock price declines or the stock is forfeited. The employee is agreeing to pay taxes on income that may never be received.

There are probably two sets of circumstances where an 83(b) should be considered. The first is where the employee already has a substantial business loss or a deduction to offset the income from the election. Another case would be when an employee has restricted stock in a private company that is expected to go public at a considerable premium to its current value. Those cases are few and far between now but were quite common in the 1990s.

Like options, restricted stock poses some significant concentration problems with client portfolios. In addition to having human labor capital tied up with their employer, restricted stock grants offer even greater exposure to the company fortunes. Many employers have no practical access to hedging tools or are proscribed from doing so by their employers. In extreme cases, it may be useful to underweight the market sector of the employer in the balance of the plan participant's portfolio. In most cases, it makes sense to sell the employer stock as soon as it vests. The best places for the proceeds are diversified equity or bond funds. Once taxes can no longer be deferred, portfolio diversification becomes a paramount concern.

"Employees should set aside cash in advance of major vesting events so that they can afford the tax liability."

The New Prescription Drug Discount Cards

Last month, Medicare beneficiaries began selecting prescription drug discount cards pursuant to last December's Medicare reform bill. Enrollment is voluntary and may continue throughout the year. There are numerous options available to them – each with their own discounts and pharmacy networks. Over 70 discount cards have been approved.

The discount card is intended as a temporary program to provide immediate assistance in lowering prescription drug costs for Medicare beneficiaries during 2004 and 2005 and will end when Medicare implements a new, comprehensive prescription drug benefit that will begin January 1, 2006. Individuals enrolled in a Medicare Advantage (formerly Medicare+Choice) plan which offers a prescription drug card for its members may only get a prescription drug card through that plan.

Medicare allows card providers to charge a maximum of $30 annually. The discounts range from 10% to 30% on name brand drugs and are higher for generics. The Dept of Human Services has an overview of the program along with links to key resources at www.cms.hhs.gov/discountdrugs/overview.asp

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