Restricted Stock Units - Case Study

Case Study – *Deferring Restricted Stock Units in Your Company's Deferred Compensation Plan*

The Challenge

ABC Corporation had an existing deferred compensation plan (DCP) that permitted the deferral of cash compensation (salary and bonus). The CEO asked the EVP or HR whether his annual RSU grant could also be deferred, allowing him to avoid paying the income tax each year as tranches of the grant vested. Further, the CEO wanted the ability within the DCP to diversify his restricted stock under certain conditions (e.g. a change-in-control or retirement). And finally, he wanted a way to understand the financial impact of deferral.

Background

Accounting changes for equity compensation programs have resulted in a significant shift by many public companies from the use of stock options to restricted stock. Stock options typically gave the executive control over the impact of taxation, with the ability to exercise the options – at their discretion – often over a ten-year period. With restricted stock, taxation is controlled by vesting – not the executive - which often occurs ratably over a shorter three to five-year period.
However, restricted stock in the form of restricted stock units (RSUs) can be deferred into a company's DCP. Then, when vesting occurs, income taxation is not triggered (although certain payroll taxes could still be due).

Creating a Simple Tool for Understanding the Benefit Deferral

To address the CEO's request for a way to understand the benefit of deferring restricted stock, ABC worked with Executive Benefit Solutions (EBS) to create an Excel modeling tool. The objective was to create a simple tool that could be given to each executive eligible to defer RSUs that would allow them to compare the projected impact of deferring versus not deferring.

As with any financial analysis, certain key assumptions are critical in determining the results. With respect to comparing the impact of deferring RSUs versus not deferring them, some of the key variables include:

- The age of the executive and the intended period of deferral. For example, a 55-year-old executive wants to defer for 10 years until expected retirement at age 65, then take distributions over a ten-year period.
- The vesting provisions of ABC Corporation's restricted stock:
    - For time-based vesting, many RSU's vest ratably over a three to five-year period.
    - For performance-based vesting, there is often a multi-year period over which the achievement of performance criteria determine the actual number of shares awarded at the end of the period.
- The applicable tax rates. There are several that apply:
    - Federal income tax rate.
    - State income tax rate, if applicable. Tax rates in some states, like California and New York, can have a significant impact.
    - Capital gains tax rate, which would apply to restricted stock that is held and not deferred, and then subsequently sold. Could also apply to reinvested proceeds of restricted stock that is sold.
    - Tax rate on dividends, if dividends are paid on ABC Corporation's stock.
    - Payroll tax rates, which apply when restricted stock units vest.
- Growth rates and investment rates:
    - The growth rate of ABC Corporation's stock.
    - The growth rate of any investment into which diversified shares of ABC stock are reinvested.
    - The dividend yield on ABC Corporation's stock, if applicable.

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With these variables as inputs, EBS was able to create an Excel Modeler that allowed each executive at ABC Corporation to enter a few simple inputs and then assess the impact of deferring versus not deferring. Executives were then in a position to make an informed decision about their annual opportunity to defer RSU grants.

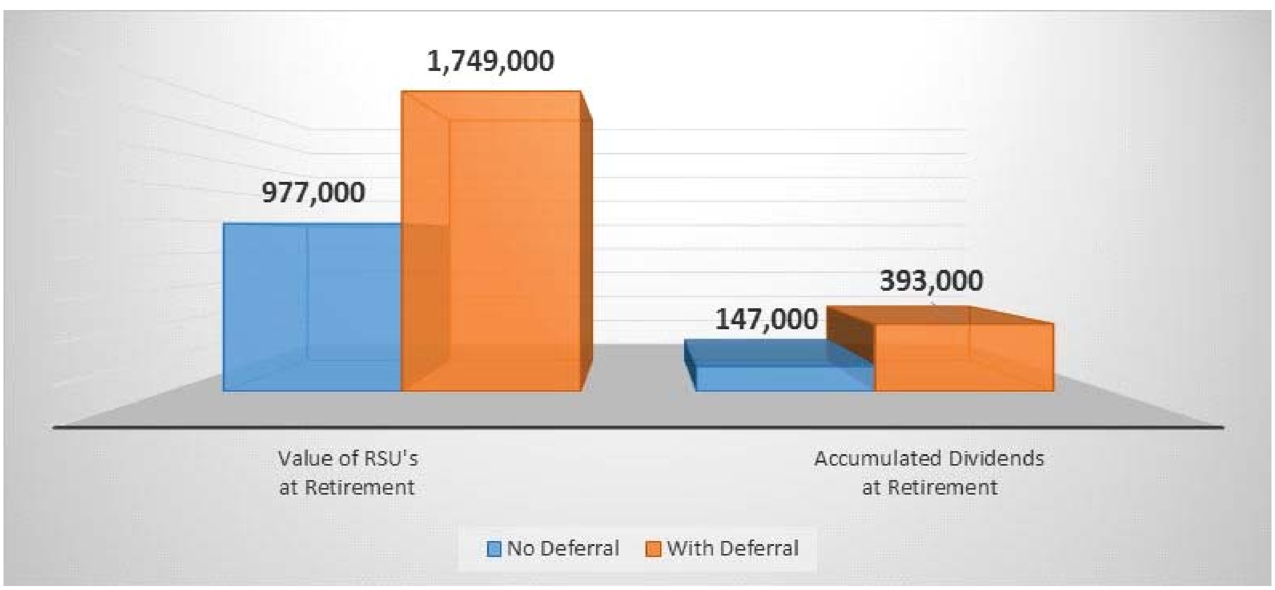
A Word on Diversification

It's not uncommon for a DCP to permit the deferral of RSU's. However, it's rare for a plan to allow the diversification of RSUs into other investment options offered in the DCP. Typically, RSUs are not diversifiable and are paid out as shares upon distribution from the DCP. This allows the company to use favorable fixed accounting for the RSU liability, eliminating any potentially volatile impact on the P&L. Unfortunately, without the ability to diversify RSU's while in a DCP account, many executives have been reluctant to defer for fear of having to hold company stock through a negative event.

However, EBS has worked with plan sponsors to implement a methodology that permits diversification while still maintaining P&L stability. With diversification of RSUs as a plan feature, executives are more interested in taking advantage of the tax benefits of deferral because they retain the ability to sell RSUs that are held in their DCP account.

Modeler Results: Deferring versus Not Deferring

The EBS Restricted Stock Modeler produces a simple graph that contrasts the executive's financial position at retirement, with and without the deferral of RSU's. The sample below assumes an RSU grant for the 55-year-old CEO of 50,000 units that vests over four years with an initial value of $20.00 per unit. Units grow at 6.00% per year for ten years until retirement, and there is a 3.00% dividend. The executive's marginal income tax rate is 45.42%, which includes both the federal rate and the state income tax rate in California.



Why is the account balance at retirement so much greater with deferral? Without deferral, 45%+ of the RSU's are sold over a four-year period to cover income taxes. The sale of almost half the shares reduces the dividends

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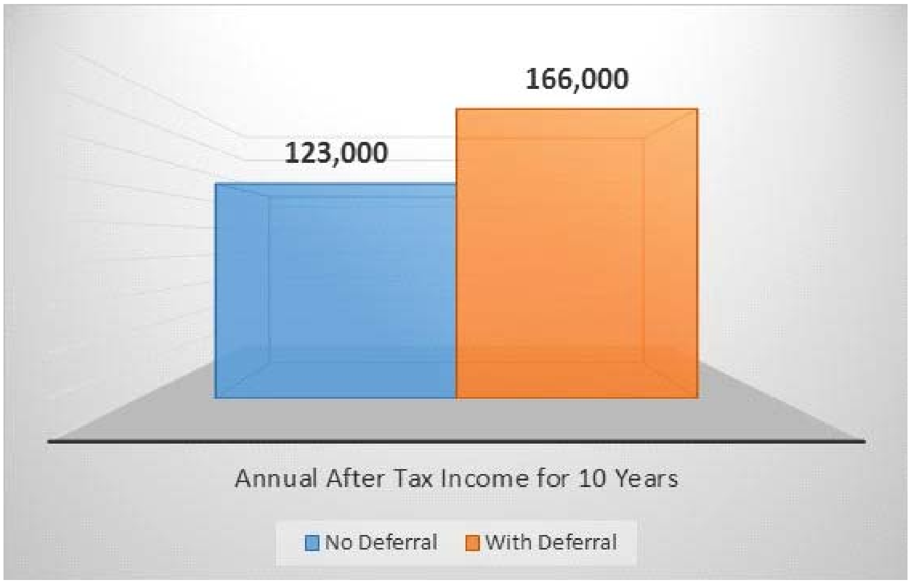
received. Further, the dividends that are received are subject to income taxes if there is no deferral of RSU's. Note, however, that without deferral, while nearly half the shares are sold when vesting occurs, the subsequent sale of the remaining shares at retirement will be subject to the lower capital gains tax. Units held in the deferred compensation plan will be subject to the higher ordinary income tax rates.

Retirement Income Comparison – Deferring versus Not Deferring

Given the balances in the graph above, the EBS RSU Modeler calculates the net after tax income available during retirement, given the two scenarios of deferring RSU's and not deferring them. Despite the fact that income distributions from the DCP are subject to ordinary income tax, while income generated from the reinvested RSU's not deferred may in part be subject to lower capital gains rates, the nearly 2 to 1 advantage in account balance at retirement results in a significantly higher net after tax income when RSU's are deferred (35% higher in the example), as depicted in the graph below from the Modeler:



The significant difference in after tax income when RSU's are deferred highlights the structural advantage of pretax accumulation. By deferring RSU's into a DCP, the executive eliminates the triggering of income tax due to vesting, and regains control over the timing of income taxation. The executive can control taxation through his distribution elections. Most DCP's today offer flexible distribution options that permit payouts both at retirement and while still working (which is useful for needs such as college tuition payments).

Look for EBS's case study on Creating a Personalized Restricted Stock Wealth Management Program, which provides guidance on how to establish a flexible wealth distribution plan using your company's DCP distribution elections and your RSU awards.

You can download a copy of the EBS RSU Modeler by visiting our website's Modeler section.

ABOUT EXECUTIVE BENEFIT SOLUTIONS, LLC

EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

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