NORTHERN TRUST

A GUIDE TO MAXIMIZING CORPORATE EXECUTIVE COMPENSATION

Wealth Planning Insights
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This *Wealth Planning Insights* discusses the attributes of common compensation arrangements available to corporate executives and offers insight into wealth planning strategies to enhance the effectiveness of their utilization in an executive's financial plan.

As a corporate executive, your compensation differs from others in your company and is comprised of fixed base compensation, performance bonuses and long-term incentives with varied attributes, often accompanied by a jumble of acronyms. For example, one of the greatest benefits available to you is equity-based compensation, which is extremely advantageous to the growth of a wealth plan. But this advantage is not without complexity. Indeed, executive compensation plans are inherently complicated — much more so than merely owning stock and waiting for its value to appreciate. There are many details that require attention and understanding, including specific company retention guidelines, performance metrics, vesting and expiration periods. And once these are addressed, it is imperative to balance your short- and long-term liquidity needs in consideration of securities laws and income taxation while also accounting for the impact market volatility has on stock valuation.

You may have access to some, all or a hybrid of the compensation arrangements discussed here. Although your employment agreement and company's policy will dictate the specifics to which you must adhere, take the time to understand the basic tenets surrounding the technical aspects and attributes of each offering. Doing so will help ensure that you maximize pertinent wealth planning strategies to meet your unique financial goals. To determine the best strategies and courses of action, you will likely need to engage in ongoing discussion with your trusted advisors.

BASE SALARY & SHORT-TERM INCENTIVES

DESCRIPTION	Annual base salary is the simplest aspect of an executive compensation plan and is often capped at $1 million due to federal corporate income tax deductibility limits. The structure of short-term incentives, paid on an annual, quarterly or monthly basis, is also fairly straightforward and typically consistent in amount and frequency.
TAXATION	From a tax perspective, salary and bonuses are subject to ordinary federal income tax, state income tax and federal payroll tax.
SPECIAL CONSIDERATIONS	Since fixed base compensation is usually a mere fraction of total annual compensation, careful cash flow planning is required to account for vacillations in income presented by the other components of the compensation package.
WEALTH PLANNING STRATEGY	**Use predictability to plan.** Salary and cash bonuses likely will be the smallest component of your entire compensation package, yet the relatively consistent receipt of salary and cash bonuses provides an opportunity to build cash reserves and forms the foundation of your compensation arrangement.

By far, your salary and short-term incentives are likely to pale in comparison to the wealth you stand to acquire from long-term incentive programs and equity-based compensation. However, salary and short-term incentives are the most predictable aspects of your compensation plan, and neither rests on stock valuation or vesting. Although base compensation and bonuses do not necessarily require specialized planning, take advantage of the certainty they provide. Consider how best to utilize them for financial objectives:

- build cash reserves to establish liquidity in your portfolio;
- minimize mortgage debt on your primary home or vacation property;
- fund a 529 Plan for future education costs;
- elect to defer a portion of compensation in your company's deferred compensation plan;
- pay the premium on an individual life insurance or disability income policy separate from your company; or
- establish a charitable gifting plan for the causes and organizations important to you.

It is important to remember that if you are an executive of a public company, details of your compensation package will be made public due to the U.S. Securities and Exchange Commission (SEC) mandate for full disclosure of executive compensation. As you tackle complex planning issues, be mindful of perceived ethical concerns as the pay gap between non-management employees and executives widens, and be willing to take an informed, principled approach to any pay equity inquiries you may face internally or externally. Likewise, be prepared to address privacy issues you or your family may be exposed to due to the public disclosure of your compensation.

STOCK OPTIONS

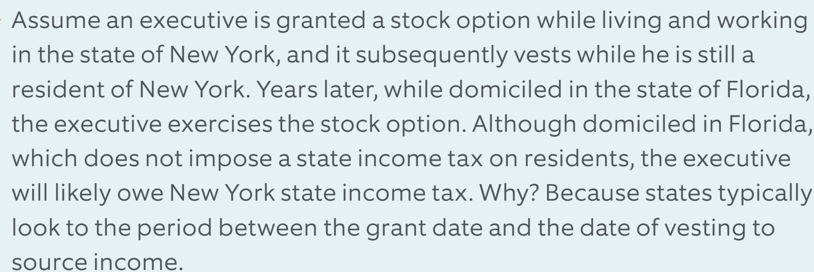
	QUALIFIED INCENTIVE STOCK OPTIONS (ISOs)	NON-QUALIFIED STOCK OPTIONS
DESCRIPTION	Both ISOs and non-qualified stock options grant an executive the right to purchase shares of company stock at a predetermined price (i.e., the strike price) during a defined period of time.	
TAXATION	• Generally no tax upon issuance or vesting. Instead, tax is deferred until the option is exercised. • There is no tax liability upon exercise; however, the difference between the strike price and the value on the exercise date is included in alternative minimum taxable income. • Provided that certain holding period requirements are satisfied, entire gain/(loss) is recognized as capital gain/(loss) when stock is sold. • Different cost basis may apply for AMT and regular tax basis.	• Generally no tax upon issuance or vesting. Instead, tax is deferred until the option is exercised. • Upon exercise, ordinary federal income tax, state income tax and federal payroll tax on the difference between the strike price and the value on the exercise date is due. • Any further gain/(loss) is recognized as capital gain/(loss) when stock is sold.
SPECIAL CONSIDERATIONS	In order to be treated and taxed as an ISO, the option cannot be exercisable more than 10 years after it is granted, and the strike price cannot be less than the value of the stock when the option is granted. Additionally, it may only be exercised by the employee and may not be transferred (except at death).	Non-qualified stock options may be transferred, which makes them a likely vehicle for gifting to family, but note that the income taxation upon exercise remains with the employee.
WEALTH PLANNING STRATEGY	**Actively manage positions.** Diligently track options, model strategies with your advisor and systematically exercise options over time — ideally, well before the end of the option life.	

Stock options are a popular form of incentive compensation. Companies generally impose a vesting schedule on both ISOs and non-qualified options, seemingly making you earn an option twice — initially upon grant and later when it eventually vests. Further, the tax treatment hinges on the holding period and, generally, where the income was earned from grant to vesting date. For these reasons, it is important to understand the technical aspects and attributes of each option granted during your tenure to determine how future exercise of the option and disposition of the underlying stock will impact your wealth.

TAX TREATMENT UPON EXERCISE:
FEDERAL AND STATE TAX CONSIDERATIONS

Building on the framework on the previous page, for ISOs and non-qualified options there is no tax upon issuance or vesting. Instead, tax is deferred until the option is exercised. For ISOs, the difference between the strike price and the value on the exercise date will be included in the alternative minimum taxable income. For non-qualified stock options, the difference between the strike price and the value on the exercise date will be subject to ordinary federal income tax, state income tax and federal payroll tax.

State income tax is simple to calculate if the stock option is granted, vests and exercised all in the same state. Issues arise when an executive is granted a stock option while living and working in one state but later vests in another state. Although the income is realized in the future for federal tax purposes, most states require income to be sourced where it is earned. Prior to vesting and exercising an option, undertake careful planning to anticipate a potential state tax hit given your future mobility and residency.



Assume an executive is granted a stock option while living and working in the state of New York, and it subsequently vests while he is still a resident of New York. Years later, while domiciled in the state of Florida, the executive exercises the stock option. Although domiciled in Florida, which does not impose a state income tax on residents, the executive will likely owe New York state income tax. Why? Because states typically look to the period between the grant date and the date of vesting to source income.

TAX TREATMENT UPON DISPOSITION

When the underlying stock from an option is eventually sold, the tax treatment is similar to that of stocks acquired in a traditional manner. To determine short- or long-term capital gain treatment, the holding period will begin on the exercise date and the cost basis will be the value on that date. Any appreciation (or decrease in value) will be treated as short-term capital gain (or loss) if the stock is held for less than one year, or long-term capital gain (or loss) if held for one year or more.

There is an important distinction for stock received from the exercise of an ISO. In addition to the one-year holding period rule, in order to receive long-term capital gain treatment there is a two-year holding period requirement from the date of the grant. If the stock is sold within two years of the grant, the difference between the strike price and the value on the exercise date will be taxed as ordinary income. It is also important to note that for ISOs cost basis could be different for AMT and regular tax purposes.

TRACKING AND EXERCISING YOUR STOCK OPTIONS

Over time, you may accumulate an abundance of stock options, all with varied attributes. It is more common than one would think for options to go unexercised, with an associated loss in value to the holder. Collaborate with your advisors to develop and maintain an option tracking system to have a clear picture of the value of your holdings at any given time. At a minimum, you should track the grant date, strike price, vesting period and expiration date. For your tracking to truly add value to your wealth plan, be certain that it calculates the theoretical value of your options, factoring in the time value of holding the stock as well as assumptions for the volatility of the company stock.

Exercising your stock options is one of the best ways to accumulate wealth, which often results in a concentrated equity position. The risk of holding a large concentrated equity position, however, is generally not in your favor — so it is essential to have a strategy to gradually reduce your holding.

Establishing a long-term plan based on your retirement date is one approach. Unfortunately, as an executive you likely do not have the luxury to exercise at will and sell the resulting net shares, due to minimum holding requirements and public relations considerations. It is best practice to actively monitor options, given the risk that they may expire or be “underwater,” rendering them worthless. A common strategy is to exercise options over time, ideally well before the end of the option life. Then, sell enough shares to pay the strike price, tax liability and transaction fees, yet hold a designated amount of net shares to demonstrate ongoing confidence in the company and satisfy the company’s minimum stock ownership requirement.

TRANSFERABILITY: GIFT PLANNING WITH STOCK OPTIONS

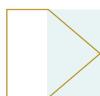
Federal tax law prohibits the transfer of an ISO during the optionee’s lifetime, thus eliminating gift tax planning with ISOs. Conversely, vested non-qualified stock options may be transferred.

If a company permits the transfer of a non-qualified stock option, transfer may be ideal for lifetime gifting. This is especially true in the case of an executive who lacks liquidity to make a cash gift, yet has a sizeable portion of their portfolio comprised of non-qualified stock options. Federal tax law only permits gifting of non-qualified stock options that are fully vested. If non-qualified stock options are transferred, the optionee remains responsible for the income tax when the option is exercised. For this reason, non-qualified stock options should only be transferred to family or to a trust for their benefit of which you retain control over the option in accordance with company policy. Transfer to charitable organizations is discouraged. If transferred to a charity, the tax benefit of the contribution would be lost due to the incurred tax liability at exercise. As a rule of thumb, it is best to gift cash or appreciated assets to charity.

RESTRICTED STOCK AWARDS

DESCRIPTION	Restricted Stock Awards (RSAs) represent grants of company stock subject to vesting, which is usually dependent on the continuation of employment or specified goals.
TAXATION	The value of the stock granted will be subject to ordinary federal income tax, state income tax and federal payroll tax upon vesting (unless income had previously been recognized under a Section 83(b) election of the Internal Revenue Code).
SPECIAL CONSIDERATIONS	An 83(b) election changes the treatment of dividends on unvested stock. If an election has been made, dividends are taxed at the favorable qualified dividend rate. If not, dividends will be treated as ordinary income.
WEALTH PLANNING STRATEGY	**Receive the grant, pay the tax.** If you believe the stock will greatly appreciate in the future, consider making an election under Section 83(b) of the Internal Revenue Code to optimize the net value of the stock.

An overwhelming majority of public and private companies offer RSAs and RSUs (Restricted Stock Units) due to the strong retention characteristic nature of such grants. Somewhat similar, these equity grants are often confused, and misconceptions can lead to very different outcomes. Note the key differences.



An RSA *transfers* the stock to the recipient on the date of grant, subject to specified vesting restrictions and conditions. RSAs come with voting rights immediately because the recipient actually owns the stock upon grant. This is in stark contrast to an RSU, which represents a right as opposed to ownership. An RSA cannot be redeemed for cash.

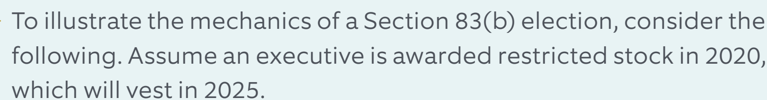
An RSU is not an actual transfer of stock on the grant date, but rather a *commitment* to transfer stock once specified vesting conditions are met. Additionally, some RSUs may be redeemed or settled for cash in lieu of stock.

RSAs and RSUs are an excellent wealth accumulation device since no personal wealth is at risk prior to vesting. But there are tax implications that must be considered.

RSA SECTION 83(B) ELECTION

With an RSA, the value of the stock granted will be subject to ordinary federal income tax, state income tax and federal payroll tax upon vesting. Additionally, if by the time the stock vests its value has appreciated since the date of grant, then not only must the initial value of the grant be taxed as ordinary income, but also the full amount of that appreciation.

However, you might be able to make a Section 83(b) election, which accelerates taxation of the initial value of the grant to the current year of the grant and also permits the deferred recognition of any future appreciation or depreciation to be taxed as capital gain or loss. Although there is potential for tax savings, there is a risk that the stock price will decline in the future or, worse, the conditions of the restricted stock are unsatisfied and vesting never occurs. If you leave the company prior to vesting or specified goals are not met, there is no deduction or refund of the tax paid at the time of election. For this reason, understand the potential risk of a Section 83(b) election before you pay tax on value you may never receive. Work with your tax advisor to determine whether a Section 83(b) is available and, if so, whether it makes sense.



To illustrate the mechanics of a Section 83(b) election, consider the following. Assume an executive is awarded restricted stock in 2020, which will vest in 2025.

- At the time of the award the stock has a value of $100,000.
- Upon vesting the stock has a value of $125,000.
- The executive sells the stock in 2026 when it is valued at $175,000.

83(b) Election

If the executive makes a Section 83(b) election, the executive will pay ordinary income tax on $100,000 for the year of grant. Upon vesting, no tax is owed on the appreciation of $25,000. However, when the stock is sold, the executive will owe long-term capital gains tax on the entire stock appreciation in the amount of $75,000 ($175,000 fair market value at sale, less $100,000 cost basis).

No 83(b) Election

If the executive decides not to make a Section 83(b) election, the executive will pay ordinary income tax on $125,000 – the value of the stock when it vests. When the stock is later sold, the executive will owe long-term capital gains tax on $50,000 ($175,000 fair market value at sale, less $125,000 cost basis).

NON-QUALIFIED DEFERRED COMPENSATION PLANS

DESCRIPTION	An income deferral plan permits presently earned income to be distributed at a future date, typically during retirement when taxable income is expected to be lower.
TAXATION	Upon receipt of the deferred income, it will be taxed at the income tax rate at the time of distribution.
SPECIAL CONSIDERATIONS	Because non-qualified deferred compensation plans are not subject to qualified plan regulations, they vary widely from company to company and can be specially customized to an executive.
WEALTH PLANNING STRATEGIES	**Use as a negotiation tool.** A non-qualified deferred compensation plan can be tailored to serve your unique needs. Consider whether you need to supplement future retirement benefits or desire early retirement incentives. Or if joining a new company, seek replacement of any benefits or bonuses you forfeited upon leaving your former company. **Time the distribution period.** Federal tax rules dictate whether a state may tax a distribution. If you select a distribution period less than 10 years, income will be taxed in the state earned. On the other hand, payments made over 10 years or more are taxed in the state of domicile.

Non-qualified deferred compensation plans are not a type of compensation, but rather a means for a company to provide an executive with tax-effective compensation. Non-qualified deferral plans are not subject to the strictures of ERISA and are therefore specially designed to cover executives. For our purposes, any reference to deferral plans is to non-qualified deferral plans.

Many companies may even match a portion of the compensation deferred. Since the purpose is to postpone receipt of income to some future date, it is expected that distribution will occur during retirement, when your ordinary income tax rate will be presumably lower than your current ordinary income tax rate.

TO DEFER OR NOT TO DEFER: KEY CONSIDERATIONS

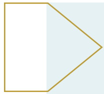
A non-qualified deferred compensation plan can be a great tool to minimize tax while accumulating wealth, especially for executives who are maximizing 401(k) contributions. Although advantageous, such plans are complex with a host of strict requirements. Before you defer, consider the following in the context of your wealth plan and risk appetite.

- **Assess the financial strength of your company.** Essentially, a deferred compensation plan forms a debtor-creditor relationship with your company. In the unfortunate event of bankruptcy of the company, deferred compensation is considered an unsecured debt. In turn, you may suffer a total loss of your deferred compensation contribution and drastically erode your wealth if your company endures financial distress.
- **Evaluate the diversity of your portfolio**. It is not uncommon for an executive's portfolio to be substantially dependent on the success of their company, being comprised of their company's stock options, restricted stock, stock appreciation rights and a 401(k) plan. With such overconcentration, participating in a deferred compensation plan may present unnecessary risk that can be significantly mitigated by adequately diversifying.
- **Calculate liquidity needs for the coming years.** Can you afford to defer income? If you believe you will need cash in the near future to fund education costs or satisfy other significant obligations, it may not be wise to have your income out of reach for several years.

HOW AND WHEN TO DEFER

If you do decide to participate in your company's non-qualified deferred compensation plan, your current and future liquidity needs will dictate your distribution election. Similar to a 401(k) plan, you must elect how to invest your contributions to a non-qualified deferred plan. On the other hand, unlike a 401(k), at the time of deferral you are required to specify the future date you will receive the compensation and the manner in which you will receive it – in one payment or equal payments over a period of years. Properly timing and planning your distributions may result in potential tax savings. Failure to adhere to the strict rules of Section 409A of the Internal Revenue Code may result in tax, interest and a 20% penalty. However, a distribution may be made without penalty if there is a change in corporate control or you leave the company, become disabled, endure a financial emergency or die.

Although tax law prohibits distribution prior to the selected deferral date or any triggering event, you may subsequently postpone a distribution. To make such a change, the election of the new distribution date must be made at least 12 months before the original distribution date. Additionally, the new deferred distribution date must be at least five years after the original distribution date. Granted, the "redeferral" process may be a bit burdensome, but it might be worth the hassle to better serve future needs or further reduce tax liability.



Assume an executive scheduled a distribution for March 2021 to remodel their home. However, after their adult children moved to another state, they decided to purchase a vacation home in the same state to spend more time with grandchildren. The executive is required to establish a new distribution date prior to March 2020 to receive payment March 2026 or later.

Consider a different executive who, in December 2015, elected to receive a deferred income distribution in December 2020. Years later, the executive's advisor shared that if a distribution period less than 10 years is selected, income will be sourced in the state earned. However, if the distribution period is 10 or more years, then each distribution will be subject to state tax in the state of domicile upon receipt. The executive recently decided to retire in a state that does not tax residents on income. The executive has until December 2019 to establish a new distribution date to receive payment December 2025 or later.

CONCLUSION

The myriad of offerings in a corporate executive compensation plan gives rise to a number of wealth planning and tax planning considerations. As you navigate the nuances of the policies established by your company, be certain to keep your personal defined goals top of mind. We encourage you to confer with your legal and tax advisors for additional guidance to maximize wealth planning opportunities.

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