BONUS SEASON 2018: FUNDING YOUR GOALS AND VALUES

Bonuses have been making headlines this year as many companies have been sharing tax cuts with their workforce. Whether you are an executive, an entrepreneur, or an employee, it is important to optimize the value of your base, bonus and equity compensation in order to align your financial success with your deeply-held goals and values.

This piece will help you understand the income tax consequences and non-tax considerations associated with your pay package if you are: An Employee or Executive or An Employee or Partner in a Partnership.[1]

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MONEY AND MEANING

Bonuses and similar financial rewards give us occasion to step back and embrace abundance over scarcity. It is helpful to reflect on our values, ideals and the impact that we want to make. This reflection helps us define the highest and best use of our wealth and allows us to align our resources with the essence of who we are.

[1] Please note that tax-qualified retirement accounts, non-qualified deferred compensation plans and non-cash benefits (including insurance and company-provided housing, cars and tuition assistance) are beyond the scope of this article. But, we encourage you to visit www.northerntrust.com for more information on these topics.

BONUS PLANNING STRATEGIES

IF YOU ARE: AN EMPLOYEE OR EXECUTIVE

Employees and executives of C-corporations and S-corporations often receive not only cash bonuses, but also restricted stock and options.

Each type of compensation is covered in turn.

Cash Compensation

Employees and executives who receive salary and cash bonuses do not need to do much specialized planning, but should consider directing bonuses toward high priority goals. Cash compensation can fund a number of financial objectives, such as:

- paying down debt;
- establishing an emergency fund;
- buying a home or vacation property;
- saving for retirement or a sabbatical;
- traveling adventures;
- donating to charity;
- funding education for children and grandchildren; and
- leaving a legacy for loved ones.

From a tax perspective, an employee will owe ordinary federal income tax (top rate of 37% in 2018), state income tax (varies by state) and federal payroll tax on his salary and bonus. Federal payroll tax for 2018 is 6.2% on the first $128,400 of wages, plus 1.45% on all wages and an additional 0.9% on all wages and compensation income over $250,000 for taxpayers who are married filing jointly ($200,000 for single filers).

Taxes on compensation	Employer	Employee	Self-employed
Social Security (on first $128,400)	6.2%	6.2%	12.4%
Medicare (no cap)	1.45%	1.45%	2.9%
Medicare Surtax (above $200,000 for single filers and above $250,000 for married filers)	N/A	0.9%	0.9%
State income tax	N/A	Rates vary	Rates vary
Federal income tax	N/A	Top rate of 37%	Top rate of 37%

Private employers generally must withhold federal, state and payroll taxes from paychecks, although employees can adjust the amount that is withheld by giving their employers a new Internal Revenue Service (IRS) Form W-4 and the equivalent state form. In order to owe less tax or possibly receive a tax refund, an employee can claim fewer exemptions on Form W-4 in order to have more tax withheld. In order to capture the time value of money, an employee can claim as many exemptions as he can on Form W-4 in order to have less tax withheld. Please note, however, that an employee may owe penalties and interest if too little tax is withheld.

Regardless of the exemptions claimed on Form W-4, bonus income is subject to withholding tax rates of 22% for amounts up to $1 million and 37% on amounts above $1 million. Be aware that an employee may have to pay the IRS the following April if 22% does not cover the total federal tax that is owed on the bonus.

If an employee switches jobs mid-year, the new employer may over withhold. This is because the 6.2% social security portion of the employment tax applies to the first $128,400 of wages, but the 1.45% Medicare portion of the employment tax applies on all wages. By law, the new employer must withhold 6.2% on the first $128,400 of wages, regardless of whether the employee already hit the $128,400 threshold with his previous employer for the year. Any over withholding will be remedied when the employee files his tax return for the year, but in the interim, there is nothing that can be done to avoid the extra withholding tax.

Restricted Stock Awards and Restricted Stock Units

Restricted stock awards and restricted stock units (RSUs) are a popular type of equity compensation. An award means that shares of stock are granted that either vest immediately or vest at a specific time in the future. A unit is simply the right to receive stock either immediately or on a future vesting date. Awards and units frequently are tied to performance, which means that the amount of stock received will be based on whether the grantee and the company meet specified performance metrics. In either case, the grantee pays tax on the day that he actually receives the stock.

> An 83(b) election for restricted stock awards can be advantageous if it is likely that the stock price will increase over time.

For example, if you receive two sets of RSUs, one that entitles you to 100 shares of stock immediately and another that entitles you to 100 shares of stock two years in the future (if you are still with the company), then you will pay federal and state ordinary income tax plus payroll tax on the fair market value of 100 shares today and income plus payroll tax on the fair market value of 100 shares in two years, when the second set of RSUs vests and you receive the stock (assuming these dates coincide).

The distinction between an award and a unit becomes a factor if a tax election is made. Someone can make a so-called "83(b) election" for restricted stock awards, but not restricted stock units. An 83(b) election means that the grantee elects to be taxed on the fair market value of the restricted stock on the date of grant, rather than the date of vesting. Although the election accelerates taxable income, it is advantageous if it is likely that the stock is worth less today than it will be on the future vesting date. The downside to an 83(b) election is that, if the stock never vests, perhaps because the grantee leaves the company (voluntarily or involuntarily) before the vesting date, he will have paid tax on value that he never received. Also, if the stock decreases in value between the grant date and the vesting date, a grantee who makes an 83(b) election will pay tax on the higher grant date value, when he could have paid tax on the lower vesting date value. These are the dangers of an 83(b) election, which is irrevocable.

Additionally, an 83(b) election changes the tax treatment of any dividends that the company pays on restricted stock awards. If an 83(b) election has not been made, dividends paid on unvested restricted stock will be treated as ordinary compensation income. If an 83(b) election has been made, dividends paid on unvested restricted stock are eligible for the favorable rate on qualified dividends (a top federal rate of 23.8% in 2018).

When the stock ultimately is sold, the tax treatment is familiar. Any appreciation above (or below) the cost basis will be treated as short-term capital gain (or loss) or long-term capital gain (or loss), depending on whether the stock has been held for more than one year. The top federal tax rate for long-term capital gain is 23.8% in 2018 and the top federal tax rate for short-term capital gain is 40.8% in 2018. The cost basis for the stock generally is the fair market value on the vesting date or the 83(b) election date (whichever is earlier) and the holding period begins on the earlier of the vesting date or the 83(b) election date as well.

EXAMPLE 1

Employee is awarded 1,000 shares of restricted stock in 2018, conditioned on Employee's continued employment with Employer. The stock vests in 2020 and Employee sells the stock in 2022. The fair market value of the stock at the time of the award in 2018 is $100 per share. The fair market value of the stock at the time of vesting in 2020 is $125 per share and the stock is valued at $150 per share at the time of sale in 2022.

	2018 Award	Federal Tax on 2018 Award*	2020 Vesting	Federal Tax on 2020 Vesting*	2022 Sale	Federal Tax on 2022 Sale±	Total Federal Tax^
No 83(b) Election	$100,000	$0	$125,000	$49,187	$25,000 long-term capital gain ($150,000 fair market value minus $125,000 cost basis)	$5,950	$55,137
83(b) Election	$100,000	$39,350	$125,000	$0	$50,000 long-term capital gain ($150,000 fair market value minus $100,000 cost basis)	$11,900	$51,250

** Assumes federal tax rate of 37% plus federal payroll tax of 1.45% and Medicare tax of 0.9%. The 6.2% payroll tax has not been included on the assumption that the employee has already earned $128,400. Any state tax also is excluded.*

± Assumes 23.8% federal tax on long-term capital gain income.

^ This chart does not reflect the time value of money disadvantage of an 83(b) election; all things being equal, it is better to pay tax in 2020, rather than in 2018.

EXAMPLE 2

Assume the same facts as above, except that the stock declines in value and is worth $80 per share at the time of the sale in 2022.

	2018 Award	Federal Tax on 2018 Award*	2020 Vesting	Federal Tax on 2020 Vesting*	2022 Sale	Federal Tax on 2022 Sale±	Total Federal Tax^
No 83(b) Election	$100,000	$0	$125,000	$49,187	$45,000 long-term capital loss ($80,000 fair market value minus $125,000 cost basis)	($10,710)	$38,477
83(b) Election	$100,000	$39,350	$125,000	$0	$20,000 long-term capital loss ($80,000 fair market value minus $100,000 cost basis)	($4,760)	$34,590

** Assumes federal tax rate of 37% plus federal payroll tax of 1.45% and Medicare tax of 0.9%. The 6.2% payroll tax has not been included on the assumption that the employee has already earned $128,400. Any state tax also is excluded.*

± Assumes the long-term capital loss is valued at 23.8% of its total because the employee can fully utilize the long-term capital loss to offset capital gain income that otherwise would be taxed at 23.8%.

^ This chart does not reflect the time value of money disadvantage of an 83(b) election; all things being equal, it is better to pay tax in 2020, rather than in 2018.

Stock Options

Beyond restricted stock and RSUs, employee stock options are another popular form of incentive compensation. They give an employee the right to purchase shares of company stock at a predetermined price (the strike price) for a certain period of time.

There are two types of options: qualified incentive stock options (ISOs) and non-qualified stock options.

- ISOs are a creature of federal tax law and an option must meet a number of qualifications in order to be treated (and taxed) as an ISO:
  - — the option cannot be exercisable more than ten years after it is granted;
  - — the strike price cannot be less than the fair market value of the stock when the option is granted; and
  - — subject to exceptions for transfers at death, the option cannot be transferable and may only be exercised by the employee. This last condition effectively eliminates gift and estate tax planning with ISOs.
- Any option that does not qualify as an ISO is a non-qualified option.

For ISOs and non-qualified options, companies generally impose a vesting schedule on the employee. For example, an employee may receive 100 options, but the options are on a 25 percent, four-year vesting schedule. This means that the employee owns and is entitled to exercise 25 of the options in year one, 50 of the options in year two, 75 of the options in year three and all 100 options in year four (assuming no options were previously exercised).

The employee does not owe tax when his options are issued, regardless of whether they are ISOs or non-qualified options. The employee also does not owe tax when options vest. Instead, tax is deferred until exercise. For non-qualified options, the employee owes ordinary federal income tax, any state income tax and federal payroll tax on the difference between the strike price and the fair market value on the date of exercise.

Understanding the variances in tax treatment for employee stock options can help you maximize your incentive compensation.

For example, assume you exercise the right to purchase 1,000 shares at $20 per share when the current market value is $30 per share. The spread is $10,000 (1,000 shares x $10 of stock appreciation). You will be subject to ordinary income tax on $10,000.

For ISOs, the advantage is that there is no tax when the option is exercised. However, the difference between the strike price and the fair market value is included in alternative minimum taxable income and could cause the option holder to be subject to the alternative minimum tax (AMT).

When the stock ultimately is sold, the tax treatment is familiar. The holding period begins on the exercise date and the cost basis is the fair market value on that day. Any appreciation above (or below) the cost basis will be treated as short-term capital gain (or loss) or long-term capital gain (or loss), depending on whether the stock is held for more than one year. That said, there is an important caveat for stock received from the exercise of an ISO. In addition to the one-year holding period rule, the holder cannot sell the stock until at least two years after the grant date in order to receive long-term capital gain treatment. If the holder sells within two years of grant, the difference between the strike price and the fair market value on the date of exercise will be taxed as compensation income.

IF YOU ARE: A PUBLIC COMPANY EMPLOYEE OR EXECUTIVE

Public company employees must pay careful attention to blackout periods, which are periods imposed by the Securities and Exchange Commission (SEC) to mitigate insider trading. During a blackout period, employees with access to material information are not allowed to buy or sell company stock. This includes a prohibition on the sale of restricted stock and the exercise of an option. If blackout periods are a concern, consider a pre-set trading plan under SEC Rule 10b5-1.

TAX REFORM IN THE SPOTLIGHT

The tax overhaul that was passed on December 22, 2017, includes a special tax benefit for employees of privately held corporations. If the corporation is a C-corporation (or an S-corporation, potentially) that issues equity compensation (restricted stock, RSUs and options) to at least 80% of employees, then eligible employees can file an election with the IRS to defer the tax that ordinarily would be due on grant, vesting or exercise. The tax generally can be deferred for up to five years. Unfortunately, the company's owners and executives cannot elect to defer their taxes.

It will be interesting to see how many employees will benefit from this new rule. It is not common practice for companies to issue equity to the vast majority of employees, so this rule may not have much impact.

IF YOU ARE: AN EMPLOYEE OR PARTNER IN A PARTNERSHIP

Employees and executives of partnerships (including limited liability companies (LLCs) that are treated as partnerships for federal income tax purposes) receive not only cash bonuses, but also partnership interests (or LLC units) and options.

Each type of compensation is covered in turn.

Cash Compensation

For partnerships and LLCs, federal tax law does not allow partners to also be employees of their partnership. Instead, partners receive "guaranteed payments" that are subject to federal income tax, state income tax (if any) and federal self-employment tax. Federal self-employment tax means that the partner pays both the employer and the employee portion of the payroll tax (12.4% on the first $128,400 of wages, plus 2.9% on all wages and an additional 0.9% on all wages and compensation income over $250,000 for taxpayers who are married filing jointly ($200,000 for single filers). However, 50% of the 12.4% and 2.9% portions is an above the line deduction against gross income for federal tax purposes, so that the partner is in the same economic position as he would have been as an employee.

One key difference is that, whereas an employee's employer handles payroll tax withholding, a self-employed partner must make quarterly estimated tax payments to the IRS. Non-guaranteed distributions of partnership income from the partnership to a partner similarly are subject to self-employment tax. Many businesses use a tiered entity structure, so that a partner can be both a partner in the operating entity and an employee of a separate partnership or S-corporation.

Partnership Profits Interests

Unlike a C-corporation or an S-corporation that issues restricted stock awards and RSUs, a service provider of a partnership who receives partnership units enters a world of complexity and tax uncertainty. In order to incentivize employees and partners, partnerships frequently grant profits interests. Profits interests entitle a service provider to share in the future upside of the company, much like an option.

The chart below summarizes the taxation of profits interests, which varies depending on whether the profits interests are granted subject to a vesting schedule or not:

TAXATION OF PROFITS INTERESTS	IS THE PROFITS INTEREST TAXED ON GRANT?	IS THE PROFITS INTEREST TAXED WHEN IT VESTS?	IS THE PROFITS INTEREST TAXED WHEN IT IS SOLD?
The profits interest is NOT subject to a vesting schedule	No, as long as either (1) the profits interest does not have an ascertainable fair market value or (2) the profits interest meets a tax safe harbor. An interest generally will meet the safe harbor unless (a) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (b) the partner disposes of the profits interest within two years of receipt; or (c) the profits interest is a limited partnership interest in a "publicly traded partnership."	Not applicable	Yes. A profits interest is often eligible for long-term capital gain treatment, although ordinary income treatment is possible depending on the deal structure and the assets inside the partnership.

Chart continued on the next page.

TAXATION OF PROFITS INTERESTS	IS THE PROFITS INTEREST TAXED ON GRANT?	IS THE PROFITS INTEREST TAXED WHEN IT VESTS?	IS THE PROFITS INTEREST TAXED WHEN IT IS SOLD?
The profits interest IS subject to a vesting schedule	No, as long as (a) the profits interest meets the safe harbor described above; (b) the partnership and the service provider treat the service provider as a partner from the date the profits interest is granted; (c) the service provider takes into account the distributive share of partnership income, gain, loss, deduction and credit associated with that interest in computing the service provider's income tax liability for the entire period during which the service provider has the interest; and (d) neither the partnership nor any partners take a compensation deduction in connection with the grant of the profits interest. Even though it is not technically necessary, service providers often file protective 83(b) elections in order to be certain that the value of the profits interest ($0) is included in income on the grant date, rather than on the vesting date when the value of the profits interest could be substantial.	No, unless the interest was not "taxed" (often at $0 value) at grant.	Yes. A profits interest is often eligible for long-term capital gain treatment, although ordinary income treatment is possible depending on the deal structure and the assets inside the partnership.

Importantly, a service provider who receives a profits interest in the partnership is considered a partner, not an employee, if not at grant then at vesting. Thus, an employee of a partnership who receives equity in the partnership might be surprised at being subjected to the self-employment tax and unable to participate in the partnership's cafeteria plan, among other consequences.

Partnership Options

In addition to profits interests, partnerships can issue options to acquire partnership interests (or LLC units). One benefit of partnership options over profits interests is that a partnership option holder is not a partner until the option is exercised, so the rule that prohibits dual partner/employee status is not a concern when the partnership options are first issued.

Partnerships, unlike C-corporations and S-corporations, can only issue non-qualified options, not ISOs. Like in the corporate context, the option recipient does not owe tax when his options are issued. He also does not owe tax when his options vest. Instead, tax is deferred until exercise (see Stock Options, above).

CONCLUSION

Executives, employees and business owners all have a different set of choices as recipients of bonus awards. However, compensation planning, as with any wealth plan, should take into consideration all of the unique aspects of your circumstances in alignment with your and your family's goals. We encourage you to confer with your trusted advisors for additional guidance.

A Summary	Corporation ("C" or "S")	Partnership (or LLC)
Cash Bonus	Taxed as compensation income when received.	Taxed as compensation income when received.
Restricted Stock Awards	Taxed as compensation income at vesting (or at issuance if 83(b) election). Taxed as capital gain when stock ultimately is sold.	Not Applicable
Restricted Stock Units	Taxed as compensation income at vesting. Taxed as capital gain when stock ultimately is sold.	Not Applicable
Non-qualified Stock Options	Not taxed at issuance or vesting. Spread is taxed as compensation income upon exercise and gain is taxed upon sale of stock.	Not taxed at issuance or vesting. Spread is taxed as compensation income upon exercise and gain is taxed upon sale of interests or units.
Incentive Stock Options (ISOs)	Not taxed at issuance or vesting. Tax generally is deferred until sale of stock (but potential AMT upon exercise).	Not Applicable
Partnership Profits Interests	Not Applicable	Generally not taxed at issuance or vesting. Gain is taxed upon sale of interests or units.

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