

Financial Planning **Update**Understanding and
Maximizing Executive Benefits

In today's marketplace, salary and bonus can represent only two-thirds or less of an executive's total compensation. The remainder is typically a combination of qualified and nonqualified benefit plans, some of which may be incentive-based and tied to the firm's profitability and share price. In fact, in a recent survey, 82% of companies reported using two or three long-term incentive vehicles to compensate senior executives.¹ To make the most of these benefits, it's important for executives to understand the types of plans available, how they're used, and how they're taxed.

Non-Qualified Deferred Compensation Plans

For executives seeking to save more than they are permitted (under IRS limits) or who are in a high tax bracket and want to defer compensation, nonqualified deferred compensation (NQDC) may offer valuable benefits. These plans allow you to defer receiving—and paying taxes on—a portion of your salary and bonus until a future date, typically when you retire and are in a lower tax bracket.

Currently, there are more than 1.3 million participants in NQDC plans with \$162 billion in liabilities.² The plans fall into two categories:

1. Salary or bonus deferral plan. You defer receipt of salary or bonus which would otherwise be paid in your paycheck. You must elect into this type of plan.

NQDC planning considerations

- If you're expecting a large bonus or compensation in a year in which you also have high income from other sources (such as a property sale or investment gain), deferring your compensation to a future year (when a triggering event occurs and income is lower) could reduce your overall tax liability.
- Consider your current tax bracket as well as your future expected tax bracket. If your tax rate turns out to be higher in retirement (or on the date your benefit becomes available), deferral could be a disadvantage.

2. Supplemental Executive Retirement Plan (SERP). "Top Hat" or "Excess Benefit" plan funded by the employer. The employer directs the plan and you do not elect into it.

In addition, a NQDC plan can be considered funded or unfunded:

Unfunded. The employer funds the plan when the benefits become due. You get the advantage of tax deferral, even if your benefit is fully vested.

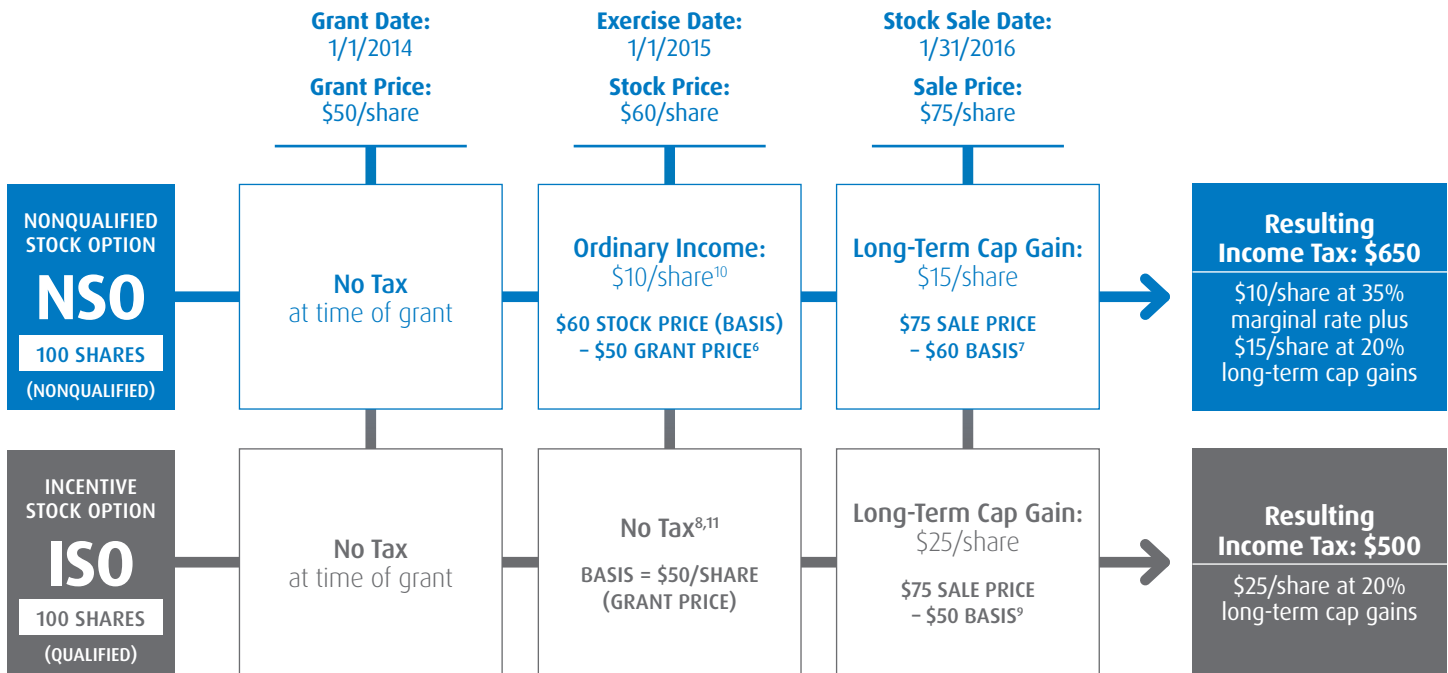
Funded. Assets have been irrevocably and unconditionally set aside with a third party for the payment of benefits. You can defer taxes in funded plans only if your benefit is restricted and payable on the condition of future performance (i.e., substantial risk of forfeiture). For example, discretionary deferrals made by an employer into the plan typically have a requirement to work for a certain number of years before payment can occur. This is a so-called "golden handcuff" designed to keep the key executive with the firm for a period of time.

Triggering Events	Taxation	Key Considerations
• Separation from service (such as retirement). Key employees³ must wait six months before accessing benefits • Disability • A date outlined in the plan • Change in company ownership • Emergency or death	• Employment taxes when services are performed or when the compensation is no longer subject to substantial risk of forfeiture • Ordinary income tax when in constructive or actual receipt⁴	• Are not covered under ERISA and do not come with guarantees that the money will be paid out • Are not qualified, so you cannot roll over the balance into an IRA or continue deferrals to age 70½

Equity-Based Compensation

A recent study showed that 86% of public company respondents have equity-based compensation.⁵ Equity-based plans provide an incentive to help grow the firm and add to the executive's overall earnings potential. Equity-based compensation can include actual shares of stock or possibly options, which give you the right to buy shares of the stock at a set price over a period of time. It can also include compensation that is based on the relative value of the company's stock.

Stock Options—NSOs vs ISOs, Including Tax Implications



NSO planning considerations

- Once the stock price is greater than your grant price, it may be time to consider exercising.
- However, if you're in a higher-than-usual tax bracket (because you sold an investment or received income from other sources, for example), exercising may not be prudent as it would increase your ordinary income tax.
- If you foresee an upcoming liquidity event or reason to anticipate that the stock might appreciate significantly, it may make sense to exercise earlier to lock in the basis for capital gains purposes.
- Evaluate your position in the company's stock; if you are holding a large number of shares after exercise, your wealth may be concentrated and unnecessarily risky, and it may be time to sell.

ISO planning considerations

The primary advantage of an ISO is the preferential tax treatment. You pay no tax when the option is granted or exercised, and only pay capital gains tax (versus ordinary income tax) when the stock is sold. Keep in mind:

- You must meet the holding period requirements in order to receive capital gains tax treatment.
- If you leave the company, you must exercise the option within three months to avoid a disqualifying disposition.
- The "bargain element" (the difference between value of the shares at exercise and the exercise price) becomes an alternative minimum tax (AMT) item when you exercise the option and retain the shares. It's important to carefully plan the timing of the exercise to consider the AMT.

Stock Options

Stock options are among the most popular forms of long-term incentive awards. There are two types: qualified incentive stock options (ISOs) and nonqualified stock options (NSOs). You don't pay tax on either when your employer grants them to you. However, the cost basis and tax due at exercise and subsequent sale differ depending on which type of option you hold (see illustration on page 2).

The date you are issued a stock option is known as the grant date. The day you exercise your right to buy the stock is the exercise date. You must pay for the stock when you exercise the option, either with cash (which may be generated from the immediate sale of the shares) or with shares of company stock, if your company's plan permits. You then have the freedom to either sell the stock or hold it for a period of time. In the case of an ISO, you must hold the stock for at least two years from the grant date and one year from the exercise date if you want the entire gain (sale price–grant price) to be taxed at long-term capital gains rates. Keep in mind that once options expire, they have no value.

Restricted Stock, Phantom Stock, and Stock Appreciation Rights

Beyond stock options, executives can be compensated with restricted stock or with other benefits that allow them to participate in stock price appreciation, such as phantom stock and stock appreciation rights (SARs). According to Hay Group, 65% of companies surveyed offered long-term incentives in the form of restricted stock or restricted stock units (RSUs).¹²

Restricted stock is stock that is granted to an executive that cannot be sold or transferred for a period of time until it is vested. It also often contains a buyback provision that allows the company to purchase unvested shares if the executive leaves the company. You can choose to accept or deny the grant when it's awarded, but you must pay for the stock on the grant date.

Restricted stock planning considerations

- Section 83(b) elections are permitted with restricted stock (but not with RSUs).
- If you leave the company before the shares vest, you forfeit the shares and any taxes you have already paid.
- Because income tax is triggered upon vesting (unless you make an 83(b) election), planning is limited to timing the subsequent sale of the shares you received.
- Keep in mind, you can use the stock to satisfy payment if you exercise NSOs or ISOs.

Ordinary income tax is triggered when the shares are vested.

However, you can opt to pay ordinary income tax on unvested stock by initiating an 83(b) election on your tax return in the year you make the election. Any appreciation in the stock price after that would be taxed at capital gains rates. This strategy might make sense if you expect the stock price to rise appreciably, as this gives you the ability to lock in the taxes on a lower value today. However, if you leave the company before you are vested, or if the shares drop substantially in value, you may end up paying more tax. Keep in mind, an 83(b) election is irrevocable and cannot be reversed (in almost all cases). Therefore, be sure to thoroughly vet this decision with your tax and financial planning professionals.

RSUs are somewhat different. At the time the award is granted, it is valued in terms of the company stock, but no shares are actually issued. Once the RSUs are vested, you receive shares and must pay ordinary income tax based on the fair market value. The shares can then be sold at any time.

Restricted stock holders pay capital gains tax on the difference between the stock's price on the date it vests and the date it is sold.

Stock appreciation rights (SARs) give you the right to share in the future value of company stock. You are awarded compensation equal to the increase in the value of a set number of shares between the grant date and the exercise date. Unlike a stock option, there is no payment required on the stock when you exercise.

Phantom stock is compensation equal to the market value or increase in market value of the stock over a set period of time. Phantom stock may also pay dividends. The award is typically contingent upon employment terms or a vesting schedule.

SAR and phantom stock planning considerations

- Consider timing exercise of SARs along with your stock option exercise; you can satisfy the payment required when you exercise a stock option with cash or stock (if issued).
- Understand the vesting schedule, expiration date, and fair market value of your company's stock when contemplating an exercise of your SARs. Ordinary income tax is triggered when exercised, and rights may expire if not exercised before the expiration date.
- Phantom stock plans typically pay out according to a set schedule, so you can't plan the timing of exercise. However, if you are expecting a payout, you may want to consider deferring exercise of other options to another tax year to avoid excessive income in one year.



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Suzie is a CERTIFIED FINANCIAL PLANNER™ professional. She received her B.S. in Global Business and Financial Management from Arizona State University and M.S. in Taxation from Golden Gate University. She serves on the Board of Directors for the Financial Planning Association of Greater Phoenix and is the Director of the FPA NexGen Group. Suzie is also an active member of the Central Arizona Estate Planning Counsel and the American Institute of CPAs (AICPA).

Other Equity-Based Plans	Type	Cost Basis	Tax at Grant	Tax when Vested or Exercised	Received when Vested or Exercised
Restricted Stock	Nonqualified	Gross income when vested + amount paid for stock	No income tax	Fair market value of stock (at vesting) ^{13, 14}	Cash or stock
Restricted Stock Unit (RSU)	Nonqualified	Gross income when vested	No income tax	Fair market value of stock (at vesting) ^{8, 15}	Cash or stock
Phantom Stock	Nonqualified	N/A	No income tax	Value of award (at exercise) ⁸	Cash
Stock Appreciation Right (SAR)	Nonqualified	Gross income at exercise	No income tax	Fair market value of stock or cash received (at exercise) ⁸	Cash or stock

Qualified and nonqualified benefit plans can represent a large portion of an executive's total compensation package. In order to maximize the benefit, it's critical to understand how these plans work and how they're taxed, and then to plan accordingly. Keep in mind, the executive plans discussed in this article are often provided in conjunction with defined benefit pension plans and defined contribution plans. Together they offer a comprehensive set of investment vehicles to help highly compensated executives save for retirement and other long-term financial goals. To learn more about strategies to maximize executive compensation, work with your financial planner.

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¹ Meridian Compensation Partners, LLC, 2015 Trends and Developments in Executive Compensation

² Source: 2015 NQDC/457(f) Buyer's Guide. As of 12/31/14

³ IRS Sec. 416(i): 5% owner, 1% owner with compensation over \$150,000, or an officer with compensation over \$130,000

⁴ Internal Revenue Code Section 451(a): Constructive Receipt Doctrine and Economic Benefit

⁵ Financial Executive Compensation Survey 2015

⁶ Ordinary income and subject to FICA and FUTA

⁷ Capital gain; long-term or short-term based on holding period

⁸ Difference between grant price and fair market value at exercise is considered an AMT preference item for taxable year of exercise

⁹ Long-term capital gain

¹⁰ \$10/share of ordinary income also subject to FICA and FUTA employment taxes

¹¹ AMT preference 2015 \$10/share (\$60 stock price-\$50 grant price)

¹² Hay Group Executive Compensation 2013

¹³ Ordinary income and subject to FICA and FUTA

¹⁴ Executive can choose to be taxed on the grant date equal to fair market value of the stock at grant date less any amounts paid for the shares (IRC Sec 83(b) election)

¹⁵ IRC Sec 83(b) election not available for RSUs

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