THE WHITE PAPER

Strategies for Managing Your Assets

July 2015

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Compensation Strategies for Senior Executives

Many corporations strive to create special compensation packages for their executives that reward these key employees for the extra value, experience, and expertise they bring to their jobs and their employers.

Known as executive compensation or incentive packages, these can take many different forms. Company stock options are some of the most common executive perks in the marketplace today.

Company Stock Options

A stock option is a simple contract that gives an employee the right to purchase shares of company stock at a preset price for a specified period of time. The option to buy becomes valuable only if the stock's price rises above the preset price at the time the employee decides to "exercise" the option and purchase the shares. The window of time for exercising an option will vary depending on the details of a particular contract -- but if it is not exercised within the specified time, the option will expire. Thus, the key to managing company stock options effectively is timing: knowing when to exercise and/or sell the stock to maximize its value and minimize any potential income tax consequences.

Nonqualified Versus Incentive Stock Options

Before a strategy can be devised for managing stock options, recipients first need to know what type of options they are holding: nonqualified stock options (NSOs) or incentive stock options (ISOs). The key difference between NSOs and ISOs is the way in which they are taxed. NSOs require holders to pay income tax on the paper profit they earn when the options are exercised. For individuals in the highest income tax brackets, this rate could be as high as 39.6%. When the stock is eventually sold, any additional price appreciation is taxed as either short-or long-term capital gains, depending on the holding period.

By comparison, ISOs are taxed only when they are sold, and if the recipient holds the stock long enough to satisfy a special holding period any proceeds from the sale qualify for the more favorable long-term capital gains tax treatment. Although ISOs do not trigger income tax when they are exercised, the holder may be required to pay the alternative minimum tax (AMT). The AMT is a secondary tax developed by the IRS to prevent high-net-worth individuals from reducing their federal income taxes too dramatically through deductions and other legal tax breaks. In the case of ISOs, AMT comes into play in the year in which you exercise an option and buy shares. AMT liability is triggered when the fair market value of the stock, when exercised, exceeds the preset exercise price -- otherwise known as the spread. The actual amount of AMT that may be owed will vary according to many variables.

Other Executive Perks

Some other forms of incentive compensation include the following:

- **Split-dollar life insurance --** This is an arrangement in which the costs and benefits of a life insurance policy are shared by the executive and the company. Split-dollar life insurance may enable executives to receive more life insurance protection than they could afford on their own.
- **Executive bonus plans --** This is simply compensation that is provided to executives in addition to their regular salary. Also referred to as Section 162 plans, these often take the form of profit-sharing bonuses paid near the end of the year that reward executives for successful performance.
- **Phantom stock--** Shares of so-called phantom stock track the value of real company stock and pay out dividends to executives based on company performance of a specified date in the future. They allow executives to reap many of the benefits of stock ownership without the company actually having to issue shares.

Being aware of the many types of executive compensation features available through your company -- and their associated tax consequences -- is crucial. It is wise to seek out the assistance of a tax professional who can analyze the tax and financial implications that a particular strategy may have on your long-term investment outlook.

This communication is not intended to be tax advice and should not be treated as such. Each individual's situation is different. You should contact your tax professional to discuss your personal situation.

Tracking # 1-387029