



EXECUTIVE GUIDE TO:

# MAKING THE RIGHT COMPENSATION DECISIONS

As a busy executive are you making  
the right decisions to best secure your  
family's financial future?



“Today, many companies require high-level executives to invest a multiple of their base wages in company stock.”

As a busy executive with significant leadership and management responsibilities, you may be so focused on day-to-day business that you only occasionally evaluate your own long-term financial situation.

Just like the cobbler who is too busy to make shoes for his own children, many savvy business executives often neglect to take the necessary time to review and optimize their own compensation packages, in the overall context of their retirement and estate plans, to best secure their family’s financial future.

You and your family may be living comfortably now, but have you taken measures to ensure that you have sufficient money earmarked to maintain your lifestyle throughout retirement? Will you have enough left over, after income and estate taxes, to leave a legacy to your heirs and/or favorite charity?

There are important steps you can take to help you maximize all of the compensation available to you while you are employed. To help you avoid common mistakes executives make in this regard, this paper will explore the following topics:

- Maximizing Your 401(k) Plan
- Qualified and Non-Qualified Plans
- The Benefits and Pitfalls of Deferred Compensation
- Additional Compensation: Stock Options and Restricted Stock
- Naming the Right Beneficiaries
- Looking Ahead

As you will see, there are many important elements to consider beyond your annual salary and bonus. Understanding what is at stake can help you ensure that the time and energy you have invested in your career will pay large dividends for you and your family, now and in the future.

An experienced advisor — not just a tax preparer or securities broker — can best help you understand and make the most of your compensation against the backdrop of your entire financial situation and life goals.

## Maximizing Your 401(k) Plan

401(k) plans are qualified “defined contribution” plans into which employees can contribute income on a pre-tax basis up to specified limits (\$18,500 for 2018); employees age 50 and older can make additional “catch-up contributions” (of up to \$6,000 for 2018). Employers may also provide matching contributions up to certain company-determined limits. The income tax deferral, the tax-sheltered growth, and the ability to obtain matching contributions from your employer combine to make 401(k) plans typically one of the most attractive strategies for executives. It is almost always a good idea to contribute the maximum pre-tax allowance. Employees can also make after-tax contributions (subject to IRS limits) to a 401(k) plan thus taking advantage of tax-sheltered growth thereafter; this could also make sense for many executives.

Although deciding to participate in a 401(k) plan may be a “no-brainer,” determining how and when to exit the plan takes a bit more deliberation. The next three sections cover some of the major considerations in this area.

### MAXIMIZING YOUR EMPLOYER’S 401(K) MATCH

Spreading out your monthly contributions may result in a greater amount of matching funds from your employer by year-end.

Some highly paid executives do not realize that if they condense their contributions into the first few months of the year they may fail to get the full amount of their employer matching funds.

This situation occurs when you select a high 401(k) contribution rate. For example, take an executive (under age 50) in 2018 making \$20,000/month (\$240,000 annually) and contributing 20%, or \$4,000/month, to his/her 401(k), with a 5 percent salary company match. This individual will have reached the IRS contribution limit (\$18,500) in mid-April and would no longer be allowed to contribute thereafter. Consequently, the executive would receive a total company match of \$4,375 since the monthly match is limited to 5 percent of \$20,000 (i.e., \$1,000) for each of the first four months plus a reduced amount for May when the employee reaches the IRS limit. If the same employee had chosen a 7 percent contribution rate instead, he/she would not have reached the \$18,500 until December and would have received a company match of \$12,000.



Plan provisions vary among employers. Make sure you monitor your 401(k) and that the amount and timing of your 401(k) plan contributions, as well as how it is invested, coordinates with your overall financial plan.

## COMPANY STOCK IN YOUR 401(K)

Today, many companies require high-level executives to invest a multiple of their base wages in company stock. The executive may have a choice as to whether he/she wants to hold that investment within his/her 401(k), outside the 401(k), or a combination of both. Whichever you choose, this should be considered in the context of your overall asset allocation to ensure that you are not over-concentrated within a single industry sector. Your financial advisor can provide counsel as to whether your overall portfolio is sufficiently diversified to mitigate your concentration of risk.



## IRA ROLLOVERS

Everyone's situation is unique, but in some cases, it may make sense to do a tax-free "rollover" of your 401(k) into a traditional IRA (e.g., termination, retirement, or certain "in-service withdrawals" which are available in specific cases). Since the investment choices under a 401(k) are limited to the specific options provided by the employer, an in-service withdrawal may provide virtually unlimited choices within an IRA. At retirement or termination from an employer, the payouts to a non-spouse beneficiary under a 401(k) may need to be taken much more quickly than under an IRA — potentially resulting in a sizable loss of tax-deferred earnings.

Keep in mind that a tax-free rollover may not be a good idea if you have lost your job and are less than age 59 1/2 because of the penalties imposed upon any pre-retirement withdrawals. However, if you are age 55 or older, special IRS rules allow you to use the proceeds from your 401(k) penalty-free, but not income-tax free, to help fund your living expenses. In order to take advantage of this rule, you must have separated from service with your employer.

Finally, assets held in 401(k)s, along with other qualified retirement plans covered by the Employee Retirement Income Securities Act (ERISA), are completely protected from creditors, except when the creditors are the Federal government (for taxes) or a former spouse (part of a divorce settlement). Although IRAs may not have this complete protection, Federal law does protect up to \$1 million in an IRA that you contributed to directly. There is unlimited protection when qualified plan money is rolled over to an IRA, so it is very important to keep records to trace the funds.

## CHANGING JOBS

If you are leaving a company for a new company and are planning to roll over your 401(k) to another qualified plan but can't do it right away, the assets can be moved to "a rollover IRA" (also known as a "conduit IRA") in the interim. A conduit IRA is a separate IRA set up to accept an IRA rollover. New contributions or commingling with other retirement plan money is not allowed. By using a conduit IRA, favorable tax treatment, such as the ability to roll the funds into a new employer's qualified plan, is preserved.

If you have multiple 401(k)s because you have been at several employers, you may want to consider rolling all of the accounts into a single IRA so you can more effectively manage your money. Having much of your assets in one account makes it easier to monitor your investments and to rebalance your portfolio on a regular basis. Many executives leave prior employer 401(k) plans intact and unattended, thereby losing the beneficial effect of asset allocation and rebalancing.

## WITHDRAWING FUNDS FROM QUALIFIED PLANS: DISTRIBUTION RULES AND RESTRICTIONS

When it is time to take a retirement withdrawal, there are several points to consider. You must determine the best way to withdraw retirement funds — in a lump sum, annuity, installment payments, or rollover to an IRA, or combination of the four. If you take a lump sum, you could always buy an annuity on your own, although it may be more expensive.

An annuity can offer you an income stream for life, plus its internal growth is tax-deferred. So, if you have a low tolerance for risk and need a steady stream of income, the benefits of an annuity can outweigh the costs. However, if you and your spouse have a family history that indicates a shortened life span, you should consider taking the lump sum. This way, you don't run the risk of not collecting the full value of your retirement account. Your financial advisor can help you make an informed decision within the context of your full financial picture, reflecting on your estate and tax situation and your lifetime cash needs. If you elect an annuity, consider whether to opt for survivorship benefits (e.g., 50%, 75%, or 100 percent "joint and survivor" benefits). If you are married and want to take the annuity option, federal law requires you to elect a "qualified joint and survivor annuity" unless your spouse waives his or her right to the annuity.

There are specific IRS rules — and some exceptions — that govern the distribution of retirement assets from both 401(k) plans and IRAs:

- Tax laws generally allow penalty-free distributions from 401(k)s and IRAs once you reach age 59 ½. However, before then, you are generally subject to a 10 percent penalty, plus income tax on the distribution. There are some exceptions (examples are noted below) to the 10 percent penalty rule. Be aware that these exceptions do not apply equally to 401(k)s and IRAs.

- Exceptions to the 10 percent penalty include the following:
  - Distributions upon separation from service. If your employment is terminated on or after the date you reach age 55, you can withdraw penalty-free from your 401(k) (but not your IRA). This has provided a “bridge” for many early retirees to fund the gap between ages 55 and 59 ½.
  - Distributions due to disability or after the employee’s death.
  - Distributions that do not exceed your current year’s deductible medical expenses.
  - Distributions that are part of a series of “substantially equal periodic payments” — also called “SEPP” or “72(t) payments.” For a 401(k), separation from service is also required — this requirement does not apply to IRAs.
  - First-time home purchase, up to \$10,000 (IRA only).
  - School tuition and expenses for you, your spouse, children and/or grandchildren, but not room and board (IRA only).
- If you are retired and have 401(k) plans with your previous employers, you must take required minimum distributions (RMDs) from each 401(k) plan at age 70 1/2. Whereas, if you have multiple IRAs, your total RMD can be taken from any of the IRAs.
- If you are age 70 ½ or older and still working for a company, RMDs from the current employer’s 401(k) are generally not required.



Another important consideration is that IRS regulations offer the opportunity to withdraw company stock from inside a 401(k) under favorable tax conditions. Specifically, under special rules, the withdrawal is subject to tax at the executive’s ordinary income tax rate on only the cost basis of the stock, which can be considerably lower than the current market value. The appreciation realized since the stock was originally purchased in the 401(k) is not taxed as income until the stock is sold by the executive. This appreciation in value of the stock, while held in the 401(k), is then taxed at the more favorable long-term capital gains rate even if the stock is sold the day after it is withdrawn from the 401(k). This tax break is often referred to as NUA, which stands for Net Unrealized Appreciation. Any appreciation in excess of the NUA is taxed as long-term or short-term capital gains at the time of sale, depending on how long the stock was held after distribution.

While any tax break from the IRS warrants through consideration, NUA is not always the best long-term strategy. It can be better to simply roll the stock over into a traditional IRA and enjoy the benefits of the tax deferred accumulation inside the IRA, if the assets are left in the IRA for a long-enough period.

The optimal strategy is going to be contingent on your unique circumstances and goals. Regardless of tax treatment, you should probably consider selling all or part of your company stock in order to diversify and reduce your downside risk, particularly if you have other assets tied to the success of the company.

#### Top Retirement Plan Tips

- Save for retirement before you save for education – otherwise, you could end up severely underfunding your retirement. Consider sharing the financial responsibility for education with your children in the form of student loans that they can assume and pay down on their own.
- Understand when you can withdraw from 401(k)s or IRAs without penalty.
- Be aware of required minimum distribution rules at age 70 ½ and how they work if you are still employed.
- Consider the effect of net unrealized appreciation (NUA) when you are taking a distribution of company stock from a 401(k).
- Realize that maxing out your 401(k) may not be enough—you may need other sources of income to maintain your current lifestyle when you retire.

## USING YOUR RETIREMENT ACCOUNTS TO FUND CURRENT CASH NEEDS

Loans are permitted from qualified plans under specific circumstances. If permitted by the plan, the maximum loan amount generally cannot exceed 50 percent of your vested account balance. And, the total amount borrowed from the plan — this loan and all others — cannot exceed \$50,000. Any greater amount could trigger taxable distributions.

## Qualified and Non-Qualified Plans

Before discussing the various compensation programs, it is important to review the differences between “qualified” and “non-qualified” retirement plans.

Qualified plans, such as most pensions and 401(k) plans, meet Internal Revenue Service Code requirements and are therefore eligible for certain tax benefits. Qualified plans are covered by ERISA, and the qualified plans’ assets are held in a trust account separate from the employer’s assets. The IRS limits the amount of compensation (\$275,000 in 2018) that can be taken into account by a qualified plan for purposes of determining benefits and contributions.

Non-qualified plans fall outside of ERISA guidelines and are designed by companies to compensate key executives and highly paid employees.



One example of a non-qualified plan is a deferred-compensation or supplemental plan which has specific provisions. Employees generally may make annual elections as to how much current compensation to defer to the future and when to begin withdrawals. These elections are usually irrevocable.

Non-qualified plan elections do not necessarily carry over from year to year. If you elect to defer 50 percent of your bonus this year, for example, it does not mean the election will be automatically triggered next year.

Many companies have other forms of non-qualified plans, including stock options and restricted stock plans. Are you eligible for any of your employer's non-qualified plans? If you do not ask or do not enroll, then you may be missing an opportunity to realize additional tax-deferred savings.

## The Benefits and Pitfalls of Deferred Compensation

A deferred compensation plan is a non-qualified plan under which an executive can elect to defer the receipt — and therefore the taxability — of a portion of his/her current salary and/or bonus to a future period, such as the start of retirement. The deferred income earns a rate of return either set by the company (for instance, the prime interest rate or prime plus some percentage) or as available from a menu of investment choices.

At the payout date, you receive, over a pre-selected period (such as 15 years), your deferred income plus the accrued income and/or appreciation on your invested balance. The benefits of compounding income on a tax-deferred basis can add up to a substantial sum over time. Note that the deferred compensation, including any appreciation and income from the investments, is taxable upon receipt. Given the deferral of taxable income and an attractive earnings rate, it usually makes sense for you to take full advantage of this plan.

### UNDERSTANDING YOUR RISK

When you elect into a company's deferred compensation program, the income you defer becomes a corporate liability, and you become a general unsecured creditor of the company. As an unsecured creditor, you stand in line behind the secured creditors of the company with respect to any deferred money. As we have witnessed with employers such as Enron, World Com and Lehman Brothers, this is an important consideration to keep in mind as you plan for the future. While the promise of future compensation in exchange for no current income taxation can be an attractive benefit of an informally



funded deferred compensation plan, there is also significant risk associated with your participation should your employer have a change in control, a change of heart or a change of financial position.

However, certain strategies can be employed that may help increase the certainty of future benefits. These methods, often overlooked, include the following:

- Rabbi trusts
- Third-party guarantees
- Surety bonds
- Indemnity insurance
- Secular trusts
- Secular annuities

## TIMING YOUR PAYOUT

The artful decision in any deferred compensation plan is the timing of the payout.

Characteristically, payouts can be elected to start at a set date in the future, or can be made at the earliest of your retirement/termination or a change in company control. Payouts can be received as a lump sum or as an annuity over a specified period of time. Each person's situation is unique. Important considerations include where you will live when retired and your projected tax bracket.

A 10-year annuity represents a compromise between extended income tax deferral and your risk as an unsecured creditor. An annuity of that length (or longer) presents the advantage that, should you establish residence in a more tax-friendly state after the payout begins, the remaining annuity payments will be subject to the income tax laws of only the new resident state. That is because tax is due on non-qualified income (e.g., deferred compensation) in the state that it is earned, unless the payment is paid out annually over 10 years or longer. Take, for example, a New Jersey employee who retires and moves to Florida the year after retirement. If he/she had a nine-year payout or less, the income will be taxed in New Jersey and he/she will need to file New Jersey tax returns as a non-resident. If the payout is 10 years or more, the payment would be subject to Florida tax law. With no income tax in Florida, the payments would be non-taxable in that state.

In comparing the overall benefit of deferred compensation to receiving the income as you earn it, consider your tax brackets now and in the future. For example, do you anticipate that your income tax rate will decrease in later years? Be sure to weigh the risks of deferral against the tax benefits, as you determine when and how much to defer and the optimal timing of the payout.

## Additional Compensation: Stock Options and Restricted Stock

Today, there is increased scrutiny of the relationship between executive compensation and company performance on the part of the public, shareholders, and the press. Consequently, in an effort to spur executive and, therefore, company performance — and to take the spotlight away from salaries and cash bonuses — employers are increasingly offering diversified compensation packages, including stock options and restricted stock. These instruments also have the secondary benefit of helping improve executive retention.



### STOCK OPTIONS

Employee stock options give the employee the right, but not the obligation, to buy a fixed number of shares of company stock at a pre-set price over a specified period of time, usually ten years. You don't own the underlying shares until you exercise the stock option, i.e., buy the stock.

Stock option grants are typically awarded after the company's Board of Directors approves the plan. The amount, grant price, vesting schedule, and term are usually beyond the executive's control. The only decisions the executive can make are when to exercise the options, which is largely an economic decision, and when to sell the shares. Economic and tax considerations are both important in making and evaluating these decisions and should be evaluated in the context of your overall portfolio and its asset allocation.

An option is "in the money" when the current market price of the underlying stock is greater than the grant price of the option. While the rewards are great if the company's stock rises, the options could become worthless if the underlying stock's value decreases below the pre-set grant price. Determining the optimal time to exercise an option is a complex matter, and is best undertaken with the help of an experienced financial advisor.

Stock options include nonqualified stock options (NQSOs), incentive stock options (ISOs), and stock appreciation rights (SARs). NQSOs are the most common type of options granted to employees, whereas ISOs are less common today. NQSOs and ISOs have common features, but differ in their income tax treatment (discussed below). Although not as popular as NQSOs, SARs are still in use. SARs give you the right to receive, in cash or company stock, the difference between the price of the stock on the first measurement date and the price of the stock on the second measurement date.

## TAXATION DIFFERENCES BETWEEN NQSOs AND ISOS

When you exercise an NQSO, the spread between the grant price and the fair market value on the date of exercise (the “bargain element”) is treated as compensation in the year of exercise and is taxed at regular income tax rates. It is also subject to Social Security and Medicare tax. When the stock is eventually sold, the gain (if any) between the fair market value at time of exercise and the sales price is taxed at capital gains rates (short- or long-term, depending on the holding period).

ISOs have more favorable initial tax treatment than NQSOs, in that — except for the Alternative Minimum Tax (see AMT and ISOs below) — there is no tax liability generated by the option exercise itself as long as you hold the stock. The growth in the stock value when the shares are eventually sold (the difference between the grant price and the sales price) can be treated as capital gains, if the stock is held for at least one year from exercise.

## AMT AND ISOS

In the year of exercise, the spread between the grant price and the fair market value on the day you exercise the ISOs (the bargain element) has to be reported as taxable compensation for Alternative Minimum Tax (AMT) purposes. If you exercise and sell the stock in the same calendar year, the bargain element is reported for regular tax purposes, but not AMT. Any AMT tax paid on the transaction results in a credit that can be used to offset the regular tax upon the sale of the underlying shares.

The AMT is a separate tax regime whose original intent, when it was instituted in the late 1960s, was to limit the effect of certain loopholes by subjecting wealthy taxpayers to additional taxes. Now, many taxpayers, not just the wealthy, are subject to the AMT. If you are a senior executive, chances are that you are subject to the AMT, particularly if you live in a state with high income and/or property taxes, and there is not much you can do to avoid it.

The AMT essentially eliminates the tax preferability of ISOs over NQSOs for those taxpayers subject to the AMT. This is the primary reason for the decline in popularity of ISOs.

## RESTRICTED STOCK

Restricted stock, which is becoming more popular as an executive compensation award, is a “promised” stock that is not fully transferable until certain conditions are met, such as continuous employment and specific performance criteria. Typically granted by public companies, restricted stock shares have substantial risk of forfeiture due to these conditions. However, once you meet the conditions and become fully vested, you become a shareholder just as if you purchased common stock in the open market. Unlike stock options, it is unlikely that your restricted stock will ever lose all of its value.

In terms of tax treatment, you don't have to report income when you receive restricted stock from an employer. However, when the stock vests, whether or not you sell it at that time, you must report the value of the stock as income, including any appreciation. The income is taxed at ordinary tax rates, and is subject to withholding, Social Security, and Medicare tax.

If you make an "83(b) election," you pay ordinary income tax in the year you receive the restricted stock rather than when the stock vests. Any appreciation that occurs in the value of the stock after the transfer date is not recognized until the stock is sold, and then, it is taxed as capital gain. If you hold the stock more than one year, you will qualify for the preferential long-term capital gains tax rate.

Unless you have other available funds to pay the taxes, it may not be a good idea to make a Section 83(b) election if receiving the stock will result in a substantial amount of income and current tax liability, since there will be no receipt of cash with which to pay the tax. Additionally, if the stock does not appreciate, or actually decreases, you may wind up paying more tax than you would have without the election.

## Naming the Right Beneficiaries

Choosing beneficiaries for your retirement accounts — and keeping your choices up to date — is, surprisingly, an area of great neglect by many executives. Beneficiary designations on retirement accounts supersede your will without having to go through probate. Naming your spouse, children, and grandchildren as beneficiaries on your retirement accounts can be a very efficient way to deliver a tax-deferred income stream to them.

It's very important to determine exactly which assets you want your beneficiaries to receive, as well as the timing of receipt, to ensure that your wishes are carried out properly. You should review your beneficiary designations periodically to make sure they reflect your current intentions and that the plan fiduciary has correctly recorded your choices.

Once you die, the beneficiary designation on file with your employer is irrevocable, no matter what you have specified in your will. Below are some common mistakes people make with regard to their beneficiary designations:

- Not changing beneficiaries after divorce.
- Not adding a new child as a beneficiary.
- Naming children outright instead of in trust. A large IRA/401(k) may go to children outright at age 18 or 21. A trust would enable you to designate when children can receive the funds.
- Not naming beneficiaries. If you die without a designated beneficiary, the distribution of assets in your retirement plans could be accelerated after your death, possibly burdening your heirs with significant tax problems.



- Not naming contingent beneficiaries. If the primary beneficiary you named does not survive you and you haven't named a backup beneficiary, it is the same as not having named a beneficiary.
- Not changing the owner/beneficiary of a life insurance policy provided by your company to a trust, if applicable. If you have created a life insurance trust, and do not transfer ownership of the policy to the trust and/or name the trust as beneficiary, the proceeds may not go where you intended.

## Looking Ahead

### IS EARLY RETIREMENT FOR YOU?

When evaluating early retirement, here are some issues for you to consider:

- Can you afford to retire? Take a look at your income and expenses now and what they will be during retirement. Don't forget one-time large expenses, such as a child's or grandchild's education. Also, remember that your assets must last a lifetime, so be sure to account for inflation, which can significantly increase your living expenses over time. An average annual inflation rate of 3 percent to 4 percent can easily more than double your expenses during your retirement years. A lifetime cash flow analysis can help you determine if you can sustain your lifestyle throughout your life expectancy.
- What type of retiree medical benefits are you entitled to? What are the costs? What are the chances the firm may take this benefit away?
- Will you be able to gain employment at a comparable level elsewhere if you desire to remain professionally active?
- Are you leaving any money on the table, such as forfeited stock options? Is your bonus based on years of service? What about restricted stock?
- Investigate the purchase of long-term care insurance to cover your healthcare maintenance costs in case of a chronic or disabling condition that needs constant supervision. Make sure you know what you are purchasing as there are currently many options (e.g., inflation provisions, payout choices, etc.)
- What are the psychological effects of leaving the workforce?



“A lifetime cash flow analysis can help you determine if you can sustain your lifestyle throughout your life expectancy.”

## NOW IS THE TIME TO OPTIMIZE YOUR TOTAL COMPENSATION

Your employment compensation is, in effect, a portfolio of short- and long-term assets. To protect your interests, you need to ensure that these assets are properly maximized, and risks are mitigated. Understanding qualified and non-qualified plans, deferred compensation, your 401(k) plan, additional compensation, and beneficiary arrangements are crucial elements in your financial planning. To make sure you get it right, the best thing you can do is consult an experienced financial advisor who can walk you through the multiple decisions and extensive paperwork that needs to be considered and completed.

Addressing these imperatives sooner rather than later will help to ensure that you and your family are financially comfortable and secure for many years to come.



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