

ADVISOR EDUCATION



Executive Compensation Guide

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Understanding Fundamental Characteristics of Common Executive Compensation Plans

Executive compensation plans have been used by many public, and some private companies, as a tool to attract, retain and motivate key employees. Participation in these plans, including stock options, restricted stock, deferred compensation and employee stock purchase plans, provides employees the opportunity to share in the success of their company, and to accumulate significant personal wealth.

These plans, however, are often very complex, with a range of unique characteristics including vesting schedules, expiration dates, gifting limitations and tax consequences, suggesting the need for competent financial counsel. In addition, plan holdings may often represent a sizable portion of the employee's net worth, requiring an integrated, comprehensive planning process around concentration risk, tax minimization, liquidity needs and charitable goals.

An educated financial professional can play a key role in this process. This guide addresses the fundamental characteristics of some of the more common forms of executive compensation, including:

- Restricted Stock and Restricted Stock Units
- Employee Stock Options (NSO and ISO)
- Employee Stock Purchase Plans
- Deferred Compensation Plans

Restricted Stock

	RESTRICTED STOCK SHARES	RESTRICTED STOCK UNITS (RSUs)
Description	<ul style="list-style-type: none"> • Awarded to compensate employees via company issued shares • Shares subject to vesting schedule 	<ul style="list-style-type: none"> • Awarded to compensate employees via units linked to performance of stock • Shares delivered at vesting • Most commonly used to avoid share dilution
Eligible participants	Employees, directors, consultants	Employees, directors, consultants
Limits	No	No
Vesting	Time (graded or cliff) or performance goals	Time (graded or cliff) or performance goals
Transferable	No	No
Term	No limit after vesting	No limit after shares received at vesting
Leverage	No	No
Intrinsic value	Yes	Yes
Dividends	Yes, taxed at ordinary rates until vested	Optional, taxed at ordinary rates until vested
Voting rights	Yes	No
Issuer expense	At vesting	At vesting
Triggering event	At vesting	At vesting
Tax treatment	Ordinary income	Ordinary income
Early exercise	83(b) election option	Not eligible
Considerations	<ul style="list-style-type: none"> • Never under water • Vesting ends for job termination • Value taxed when shares vest (Fed, State, Social Security, Medicare) 	<ul style="list-style-type: none"> • Never under water • Vesting ends for job termination • Value taxed when shares delivered at vesting (Fed, State, Social Security, Medicare)

Source: PIMCO, Investopedia

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Stock Options

	NONQUALIFIED STOCK OPTIONS (NSOs)	INCENTIVE STOCK OPTIONS (ISOs)
Description	<ul style="list-style-type: none"> • Provides employee opportunity to purchase shares at a fixed, pre-determined exercise price • Most common form of stock options granted • Options awarded to link employee compensation to share performance 	<ul style="list-style-type: none"> • Provides employee opportunity to purchase shares at a fixed, pre-determined exercise price • Selectively issued to highly compensated employees • Options awarded to link employee compensation to share performance
Eligible participants	Employees, directors, consultants	Full-time employees only
Limits	No	Max \$100,000 grant value can vest in any calendar year
Vesting	Time (graded or cliff)	Time (graded or cliff)
Transferable	Yes	No, except at death
Term	Expire, generally 10 years	Expire, generally 10 years
Leverage	Yes	Yes
Intrinsic value	No	No
Dividends	No	No
Voting rights	No	No
Issuer expense	At exercise	At exercise
Triggering event	At exercise	Sale of stock
Tax treatment	Ordinary income	LTCG potential under qualifying disposition
Early exercise	83(b) election option	83(b) election option
Considerations	<ul style="list-style-type: none"> • May be under water or expire worthless • Investor must fund purchase unless using cashless exercise • Finite life 	<ul style="list-style-type: none"> • May be under water or expire worthless • Investor must fund purchase unless using cashless exercise • Qualifying disposition: Stock must be held two years from grant date and one year from exercise date to qualify for favorable treatment. Will trigger AMT preference item in year of exercise • Finite life

Other Compensation

	EMPLOYEE STOCK PURCHASE PLAN (ESPP)	NON-QUALIFIED DEFERRED COMPENSATION (NQDC)
Description	<ul style="list-style-type: none"> Allows participating employees to purchase company stock at a discount of up to 15% from fair market value using after tax payroll deductions Nondiscriminatory plan allows for broad-based employee participation; offered by many public companies Offered as a qualified or non-qualified plan 	<ul style="list-style-type: none"> Allows selected employees opportunity to defer a portion of annual income above qualified plan limits until a specific date in the future Federal income and state taxes are not paid on compensation deferred Funds grow tax-deferred until employee receives income
Eligible participants	Full-time employees only - must be made available to all eligible employees if offered	Full-time employees only, often highly compensated
Limits	Max \$25,000 purchase per calendar year	No IRC 409A limits, but plan may impose
Vesting	Immediate	N/A
Transferable	Yes	No
Term	N/A	Triggering events as specified in plan
Leverage	No	N/A
Intrinsic value	Yes	N/A
Dividends	Yes, when paid to shareholders; reinvested automatically	N/A
Voting rights	Yes	N/A
Issuer expense	On discount	At distribution
Triggering event	Sale of stock	At distribution
Tax treatment	<ul style="list-style-type: none"> Qualified: Discount and cap gain taxed at sale (may be long-term with qualifying disposition holding period) Non-qualified: Discount taxed at purchase date as ordinary income; capital gain at sale 	Ordinary income (federal, state) deferred until distribution
Early exercise	N/A	N/A
Considerations	<ul style="list-style-type: none"> Lookback provision: purchase price may reflect discount from the lower of the share price at the beginning/ending of purchase period 	<ul style="list-style-type: none"> Triggering events: specified date, separation, retirement, death, disability, change of control Early distributions on NQDC plans trigger heavy IRS penalties Not protected under ERISA – subject to default risk Loans, rollovers not permitted May be able to choose between a lump sum distribution vs. flexible distribution

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