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Executive Compensation: A Guide to Building Wealth

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Overview

The Internal Revenue Service's (IRS) imposed limits on contributions to qualified plans has created the need for highly compensated business professionals to have additional ways to replace their working income during retirement. There are several factors that need to be considered by participants of executive compensation programs in order to: 1) increase their potential to create wealth and 2) minimize their tax burden. The need for financial advice arises due to the complexity and variety of plans and subsequent strategies that can be implemented on behalf of plan participants. This article briefly highlights some of the considerations for business professionals that are participants in executive compensation programs.

History

Per the Survey of Consumer Finances conducted by the Federal Reserve Board, the number one reason for individuals to save and invest is to **fund their retirement**. Over the past three decades, the evolution of defined contribution plans like the 401(k) has shifted the responsibility to individual investors to provide income for their retirement years. Prior to that, defined benefit pension plans put the responsibility on corporations to provide retirement benefits. This was a fairly sophisticated process involving actuaries and large investment firms which had the responsibility to provide investment returns that provided benefits to thousands of workers. Due to a multitude of factors including reduced corporate profit margins, increased fixed costs from globalization and subpar returns from lower interest rates, this giant responsibility has been handed off to individual investors living busy and complex lives. The logical question is: "How equipped is today's business executive to deal with this new responsibility"? And further, "Can a successful retirement be achieved without proper financial advice?"

An Example

Here's the case of Hank. He's a business executive for a Fortune 100 company.

Here's his profile…

Marital Status: Married 10 years with 2 children (ages 6 and 8)
Years of Service: 12 years
Current Age: 41
Desired Retirement: 65
Last Year's Compensation: $260,000
Current Net Worth: $510,000 of which about $320,000 is retirement savings with a high concentration in his employer's stock

Finally, he is a participant in the company profit sharing plan (e.g. 401k) with an employer match. He also participates in a separate defined contribution plan that his employer contributes a percentage of his salary. Hank is eligible for the executive compensation program which includes annual awards of both stock options and restricted stock units.

The first thing we identified for Hank was a strategy to increase salary deferrals to the IRS limit which worked to lower his taxable income. This was beneficial to minimize alternative minimum tax ("AMT") exposure should we decide to employ a strategy to reduce company stock holdings by the exercise of stock options and/or sale of restricted stock units.

The next thing we identified was to convert his current medical plan to a high deductible health plan ("HDHP") in order to utilize the health savings account ("HSA") feature. This allowed for all contributions made to the HSA to be "above the line deductions" which became dollar for dollar reductions to taxable income also. As a bonus, Hank's employer contributes a few hundred bucks (annually) for his participation in the HDHP with HSA feature.

Both of these strategies amounted to nearly **$10,000** in taxable income reductions to the client. The compounded tax deferred savings on this money will be instrumental in accelerating the retirement savings strategy that we have in place for Hank.

Other Considerations:

- **"Taking the Lump-Sum (or Not)"** - For defined contribution pension plans like target benefit and money purchase plans, there are special taxation options for lump-sum distributions that need to be reviewed plan by plan. Many considerations such as low interest rates, spouse's expected retirement benefits, employer's pension health, etc. have to be taken into account to arrive at the best solution.
- **"Focus on How Much You Can Keep Also"** - Although executive compensation plans are an excellent way to create wealth in non-qualified taxable accounts after IRS limits have been reached in qualified accounts, special tax strategies need to be reviewed and employed to avoid unnecessary taxation. Certain planning strategies such as tax loss harvesting and asset allocation can be implemented to allow all sources of compensation (including qualified and non-qualified accounts) to create wealth and minimize taxation (including AMT).
- **"Know What You Have"** - Employer stock awards can come in various forms and it is imperative to know the differences to avoid unnecessary taxation. Here are just a few:
  - Stock Appreciation Rights (SARs)
  - Incentive Stock Options (ISOs)
  - Nonqualified Stock Options (NSOs)
  - Restricted Stock Units (RSUs)
  - Restricted Stock

  Your employer's retirement plan documents must be carefully reviewed in order to understand any restrictions regarding holding periods, employment status, transferability, beneficiary rights, etc.

For more information, give us a call at 214-699-7599.