Navigating the Complexities of Executive Compensation

by Bryson J. Roof

There is more to executive pay than salaries, bonuses and common benefits such as health insurance, retirement accounts and vacation time; deferred compensation and stock options are an integral part of the total compensation package. With a wide array of incentive programs ranging from restricted stock to stock options and deferred compensation, how are you supposed to maximize your benefit?

It is Always Best to Start at the Beginning

Before making a haphazard decision, create a financial roadmap. Detail your financial goals, viewing your finances holistically. Accounting for 401(k)s, IRAs, brokerage accounts, stock options and deferred compensation allows you to quantify the impact of a singular decision on the aggregate portfolio.

For example, if you are participating in an Incentive Stock Option Program (ISO) there isn't a taxable event at the exercise date; however, it is important to understand the exercise is calculated into the Alternative Minimum Tax (AMT) trap. Additionally, if the stock acquired through the exercise is sold prematurely – within one year of the of the exercise date or two years from the grant – the favorable capital gains rate is lost and subsequently increased to earned income rates. A more simplistic example occurs when an executive has stock options and a deferred compensation program. If the executive has the ability to spread liquidity events over separate calendar years, the potential to avoid reaching higher tax brackets exists. The real question is which do you liquidate first, the stock option or the deferred compensation? There isn't a cookie cutter answer; it varies per each executive's unique situation. The executive must consider account values, impact of taxation and the potential risk versus reward.

Through a combination of deferred compensation and stock options, typically a large portion of a corporate executive's net worth directly correlates to their company. This is not by accident; in-fact, this is by design. While there is a fiduciary responsibility to the shareholders of a public company, tying an executive's wealth to the corporation aligns the success of the business to their financial prosperity.

An additional benefit of constructing an objective financial plan is the ability to create a suitable Investment Policy – a clearly defined investment approach based on income needs, time horizon and risk tolerance. A key advantage of an Investment Policy is determining the appropriate diversification of assets. Strategically planning the liquidation of stock options throughout your tenure spreads taxation over multiple years, as well as reducing your exposure to a singular asset and the potential volatility.

Follow the Yellow Brick Road

While devising a financial road map is extremely important, it's not as simple as following the yellow brick

road. Flexibility is vital to your success. Readdress the plan as individual circumstances morph, tax laws change and the financial markets fluctuate. An unexpected buyout offer not included in the financial plan warrants a discussion with your investment advisor to determine if the proposed package and current asset base is capable of sustaining the required income to maintain your current lifestyle.

Coordinate with Trusted Advisors

Be mindful of the one-stop shop advisors claiming expertise in every facet of your financial journey. At this stage in your life, you have achieved the level of success where you are facing multiple, and often complex, financial challenges that necessitates specialists for investment management and tax advice.

With the current volatility in the market and ever changing taxation landscape, it is impossible to remain an expert on both fronts. By segregating the investment advisor and tax advisor you have effectively created a team of experts working on your behalf. Both provide professional insight from differing vantage points and add a layer of checks and balances. The oversight of two experts makes certain you are optimizing investment opportunities and tax advantages, which becomes extremely critical during retirement. Charging an independent investment advisor to produce income from your portfolio and to coordinate with your tax advisor to take advantage of different account registrations to create the ideal blended tax rate in retirement is paramount.

Bryson J. Roof is with Roof Advisory Group Inc., an independent investment management and financial advisory firm based in Harrisburg. The firm is a fee-only registered investment advisor providing portfolio management and financial planning services to individual and institutional clientele. The firm's e-mail address is invest@roofadvisory.com