Executive Benefit Strategies Every Estate Planner Must Know

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Disclosures and Thanks

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Thanks: Thank ***you*** for inviting me today! Thanks to **ChatGPT** for assistance with my graphs. And, of course, thanks to **Congress**, the **DOL**, and the **IRS** for always giving me material!

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Agenda

- What are “Executive Benefits”?
- Why Are Executive Benefits Important to Estate Planners?
- Understand plan designs and how they impact the client’s estate plan
  - Plans that grant equity
  - Plans that “grant synthetic” equity
- Case studies throughout

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“Executive Benefits” is very broad term

- Bonus plans
- Traditional nonqualified deferred compensation
- Split dollar plans
- Stock Options (Incentive and Nonqualified)
- Restricted Stock
- “Synthetic equity” – Phantom Equity and Equity Appreciation Rights
- Practitioners from *all disciplines* involved in plan design and implementation
- Important for estate planners to understand different plan designs and how they impact the estate plan

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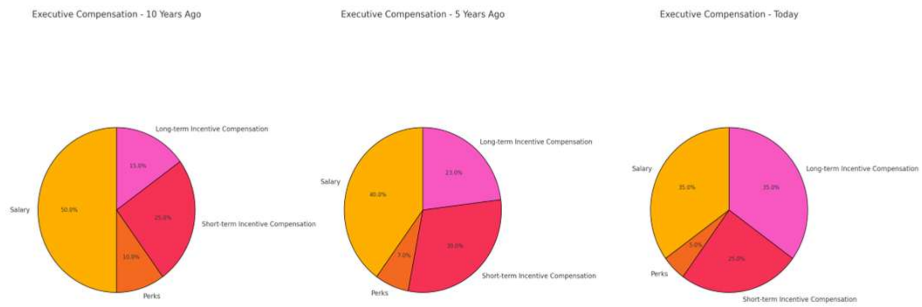
Executive Compensation Landscape



- Salary decreased from 50% in 2014 to 35% in 2024
- Perks decreased from 10% in 2014 to 5% in 2024
- Short-term incentives stayed relatively stable – 10% vs. 7% vs. 5%
- **Long-term incentives increased from 15% in 2014 to 35% in 2025**

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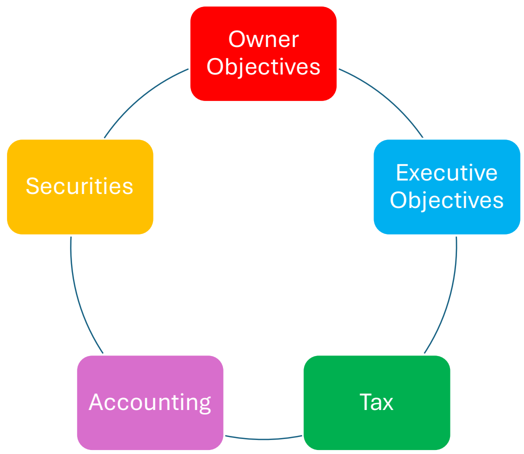
Multiple Considerations



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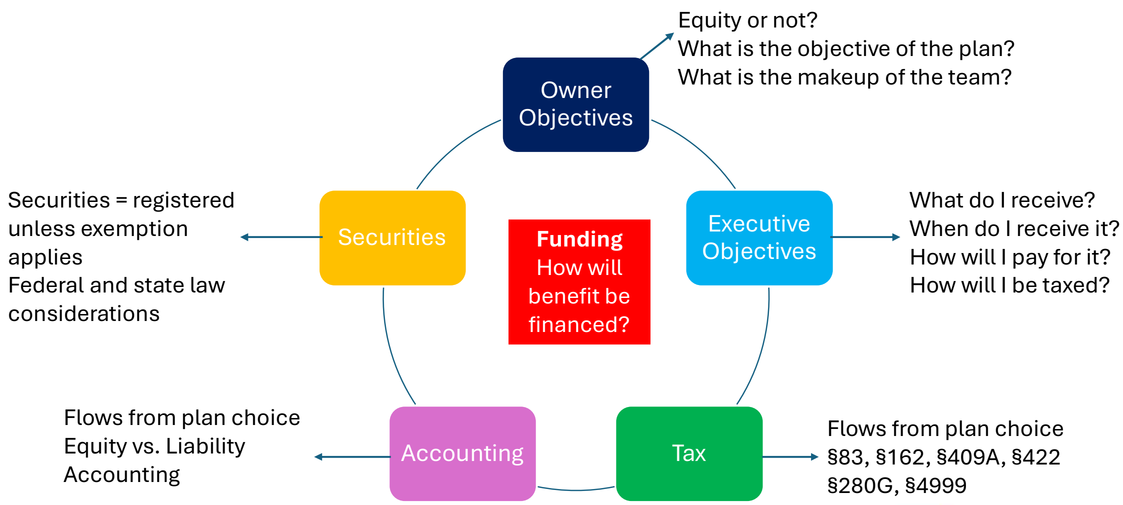

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Two Buckets

Equity Plans

- Incentive Stock Options (ISOs)
- Nonqualified Stock Options (NQSOs)
- Restricted Equity

No Equity

- Cash Bonus Plans
- Split Dollar Plans
- Traditional Nonqualified Deferred Compensation Plans
- “Synthetic Equity Plans”
  - Phantom Equity
  - Appreciation Rights

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What Objectives Are Met?

Plan	Recruit	Retain	Reward	Succession
ISOs	X	X	X	X
NQSOs	X	X	X	X
Restricted Equity	X	X	X	X
Cash Bonus Plans	X	X	X	
Split Dollar Plans	X	X	X	
Traditional NQ	X	X	X	
Phantom Equity	X	X	X	
Appreciation Rights	X	X	X	

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Plans that Grant Equity

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Plans that Grant Equity – Incentive Stock Options (ISOs)

- C corporations **only**
- Grant the right to buy:
  - a fixed number of common shares,
  - at a fixed price,
  - over a specified period, and
  - may include a vesting schedule and/or other terms
- If holding period requirements met, then income tax ***only*** upon sale of the acquired stock (at capital gain rates)
  - **Holding Period**: Stock must be held until at least 2 years from the date options were granted, and at least 1 year from the options were exercised
- *Very specific* rules under IRC §422 (i.e. not flexible)
- Any stock option that does not meet the requirements of §422 is a nonqualified option

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Plans that Grant Equity – Nonqualified Stock Options (NQSOs)

- C corporations, S corporations, LLCs taxed as partnerships
- No tax at time of grant
- Tax at exercise on the difference between the “strike price” and the fair market value of the equity being purchased
  - Compensation taxed as ordinary income
- Tax upon sale of the stock at capital gain rates on the difference between the sale price and the basis (generally amount paid + amount taxed)

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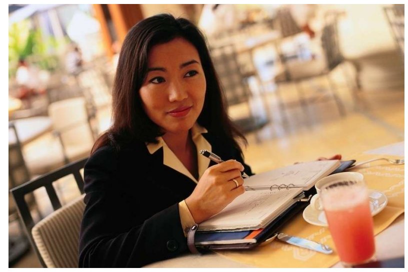
Income Taxation Comparison: ISO and NQSO

1/1/22 Natalie receives an option allowing her to buy 400 shares of company stock at $50 per share ($20,000 cost)

1/1/23 Natalie exercises her option when the stock price is $75 (FMV – Strike Price = $10,000 "bargain element")

1/1/25 Natalie sells the 400 shares of stock at $100 per share ($40,000 sale price)



Taxable amount at:	ISO	NQSO
Grant (2022) at $50	$0	$0
Exercise at $75	$0	$10,000 ordinary
Sale at $100	$20,000 cap gain	$10,000 cap gain

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For Estate Planning Purposes:

- ***No*** ISO transfers during life
- ISO transfers permitted at death to a designated beneficiary (if plan permits) or by "will or the laws of descent and distribution"
- ISOs must be exercised within *12 months* of employee's death or "permanent and total disability"
- NQSOs – transfer and exercise per plan document

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Caution:

- Beneficiaries/heirs will need ***<u>liquidity</u>*** to exercise the options
- **<u>Life insurance</u>** can provide the needed liquidity
- In closely held companies - after options exercised, how can stock be monetized?

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NQSOs For Retention and Succession

- S corporation owner desired to transition ownership to employees
- Explored ESOP not a fit
- Desired to retain control
- Desired executives to have "skin in the game"
- Desired incremental transfers

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Solution

- Recapitalized company into voting and non-voting stock
- Established NQSO Plan for Nonvoting Stock
- Annual Valuations – avg 35% discount
- Grants based upon salary, position, and length of service
- Employees could use their annual bonus to purchase stock – annual grants, no vesting
- Shareholders agreement governed permitted transfers (to trust for estate planning) and re-purchase at termination of employment

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A Happy Ending

- Company sold in Q1 2024
- $12.5M cash at closing + future payments
- Employee payouts at close ranged from $8k - $320k
- Share in future payouts
- Long Term Capital Gains

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Plans that Grant Equity- Restricted Equity

- Available to C corporations, S corporations, LLCs taxed as partnerships
- Grant of equity in the company (stock or units) which is subject to a *vesting schedule*
- No tax at the time of grant
- Taxed when no longer "subject to a substantial risk of forfeiture" (generally at vesting)
- Taxed at ordinary income rates under §83 of the Code (transfers of property for the performance of services)
- Section 83(b) election accelerates tax and may result in lower overall tax

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Restricted Stock – A Pros and Cons Story

- Clay was the 100% owner of an S corporation
- Service industry with a very high client concentration
- Wanted 3rd party sale; couldn't get the $
- President of the Company, Karen, wanted ownership; Clay wanted a successor
- Negotiated receipt of restricted stock in lieu of annual bonus

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Solution

- Restricted stock plan with 10% grants to Karen in years 1-4; 9% in year 5
- Shareholder agreement requires Karen to purchase the remaining stock if Clay dies or becomes disabled
- Value of 10% - 2021 $500k, 2022 $550k, 2023 $700k
- What does the future hold?

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Plans that Grant Equity – Planning Challenges

- Inclusion in gross estate for estate tax purposes
- Valuation issues
- Options and restricted equity result in *additional equity owners*
- Does the owner have the right to transfer the equity to a trust (revocable vs. irrevocable)? Are there conditions? Are approvals required?
- What happens to the equity if the owner dies or becomes disabled? (Ex: Mandatory purchase? Optional purchase?)
- Do the new owner's estate planning documents need to be amended or revised due to equity ownership (for example, if purchasing/receiving shares in an S Corp?)

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Plans that Do Not Grant Equity

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Synthetic Equity Plans

- "Synthetic equity" plans are **nonqualified deferred compensation plans** where the ultimate benefit to the executive is a generally a cash payment based upon the performance of company equity
  - Frequently subject to a vesting schedule
  - Like other NQDC plans, the payment must be made at the time of a "Permissible Payment Event" under §409A of the Code
- "Phantom Equity" (Stock or Units) and Appreciation Rights

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Synthetic Equity

- Deferred compensation plan subject to the provisions of §409A
  - Failing to meet requirements has serious adverse tax consequences
  - All vested accrued benefits become immediately taxable
  - The taxable amount is also subject to a 20% penalty and interest charges

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§409A Permissible Payment Events

When does it pay?

- Separation from service
- Death
- Disability (defined in §409A)
- Change in Control of company (defined in §409A)
- Unforeseeable emergency
- At a specified time or pursuant to a fixed schedule

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Vesting vs. Payment

- "Vesting" refers to the participant's ***right*** to a payment
- Cliff vs. graduated
- Time based, incentive based, or a combination
- Generally, not subject to specific rules, but the creativity of the client and advisors
- Vesting may be accelerated upon the occurrence of certain events

- "Payment" refers to when the vested portion of the participant's benefit is actually paid
- Taxation generally triggered by payment
- Payment may be subject to specific rules (i.e. §409A "Permissible Payments")
- Under §409A, payment may not be accelerated ***unless*** rules met

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Phantom Stock/Equity

- Right to receive cash at a specified date in the future based upon the performance of company equity over a specified period of time
- “Full Value Plan”
- Available to C Corporations, S Corporations, LLCs taxed as Partnerships
- May include “dividend equivalent rights” – cash bonuses paid when owners receive distributions

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Phantom Stock/Equity: Taxation

Executive normally taxed at *ordinary income rates* (and company gets a deduction) when benefit is paid

Anna receives 1,000 shares of phantom stock which will pay a benefit only upon a Change of Control

- *No tax at grant or vesting*
- *Taxed only when paid upon change of control*

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Uses of Phantom Equity

- Owners do not want to dilute ownership
- Owners only want to pay a benefit to participants upon specified events (like Change of Control)
- Recruiting – where recruits want a piece of the pie
- Retention – time vesting, performance vesting
- Ownership transition – Solidifying the executive team through a Change of Control or succession planning

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Phantom Stock for the Nonfamily Executive

- Multi-generational family business (Mfg.)
- Widowed mother controls the majority share through a QTIP Trust
- Son (Co. President) died suddenly – shares in trust for his three children; Daughter does not desire to run the company
- Recruited seasoned key executive – concerned about possible sale and wants equity

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Solution

- Granted 10% interest in the Company as phantom stock
- Vests over 10 years
- Accelerated vesting if:
  - Certain financial benchmarks are met
  - Change of Control
  - Death or Disability
- Dividend equivalent rights in vested shares

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Solution

- Payouts:
  - Change of control
  - Death
  - Disability
  - Involuntary termination other than for Cause
  - Voluntary termination after fully vested

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Equity Appreciation Rights

- Right to receive cash equal to the difference between (a) the value of X units of equity on the grant date, and (b) the value of X units on the exercise date
- Executive is taxed and the company receives a deduction when the benefit is paid
- Available to multiple entity types

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Equity Appreciation Rights

- *Rob receives a grant of appreciation rights in 1,000 shares when the stock is worth $5 per share. At exercise, the stock is worth $10 per share. His benefit is $5 per share*
- *Rob will pay tax on the $5,000 at ordinary income rates (and the company will receive a corresponding deduction) when the benefit is paid*

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Uses of Appreciation Rights

- When the owners do not want to be diluted
- To recruit, retain or reward
- To provide an incentive tied to the company's success
- If the equity fails to appreciate after the grant date, the participant gets nothing
- Flexibility to add conditions to exercise – vesting schedules, termination of benefit if executive leaves the company

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Appreciation Rights as "Sweat Equity"

- Financial investor purchased service company
- Realized that he needed a "partner" with industry experience to scale
- Experienced executive does not have free cash flow to invest
- Owner does not want to give equity "for free", especially since he recently purchased the Company

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Solution

- Owner grants “partner” unit appreciation rights
- Grant value is based upon the value of the owner’s investment
- Time vesting + acceleration if certain financial benchmarks are met
- Payouts – Change of Control, death, Disability, involuntary termination other than for “Cause”, voluntary termination after attaining “Normal Retirement Age”
  - Change of control payout on same schedule as owner
  - Other payouts over five (5) years – Controls tax for the executive and does not burden the Company

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Synthetic Equity – Planning Challenges

- Inclusion in gross estate for estate tax purposes
- Valuation issues
- Plan documents and/or award agreements generally permit the participant to **designate** a beneficiary – must follow documentation requirements
- Plan documents generally have a “default” beneficiary that is frequently the participant’s “estate”
- Benefits paid to heirs are income in respect of a decedent
- Company may desire to “informally finance” with life insurance

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Why Use Life Insurance to Informally Finance?

- Tax deferred cash accumulation
- Tax-free access to policy values via withdrawals and loans
- Company receives tax-free death proceeds
- Cost recovery from proceeds

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What is **the** most important step when dealing with executive benefits in the client's estate plan?

Read the Plan Documents!!!

Questions and Answers

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