NAVIGATING NON-CASH COMPENSATION

A Case Study

Wealth Enhancement Group®

WITH MORE OPPORTUNITY COMES MORE COMPLEXITY

As your career grows and flourishes, you will find yourself with more responsibilities and opportunities. More opportunities mean more compensation, and often more types of compensation.

These new types of compensation, such as Restricted Stock Units (RSUs) or deferred compensation plans, come with new decisions to make, adding complexity to your financial plan. At the point in your career when your work is keeping you busiest, it can be hard to keep your financial plan in focus.

Jackson and Michelle Hyde know all about it. Jackson joined his friend's startup, Sharpgen Ideas Inc. (SII), about 18 months ago as Vice President of Marketing. Seven years ago, Michelle took a position as Chief Technology Officer of Excitement Photon Solutions (EPS).

As an executive at a startup, Jackson receives a substantial portion of his salary in the form of restricted stock. The company is growing steadily and he just received good news—a promotion to EVP, Chief Marketing Officer. In addition to a salary increase from $300,000 to $400,000, Jackson will be eligible for deferred compensation on top of the RSUs he was granted when he joined the firm last year.

Michelle is in her dream job. Her company recently celebrated 50 years of pioneering photon technologies. In addition to a $315,000 salary, she has built up $750,000 in deferred compensation. She also has a 401(k) with her previous company, which includes $800,000 of appreciated company stock.

While they both love what they do, they would like to retire soon. They are 59; Jackson hopes to retire by 64, while Michelle plans to retire at 62. Their twin daughters are juniors in high school and are considering private colleges. With upcoming home updates also on their to-do list they want to make smart choices about accessing funds for their short-term needs while keeping their long-term goals on track.

THE HYDES

So far the Hydes' plan has been working. They've built up a retirement nest egg worth over $4 million. In addition to the retirement savings outlined below, the Hydes have saved $35,000 in 529 plans for each of their daughters and they have a Health Savings Account with $17,000.

	JACKSON	MICHELLE
Previous 401(k)	$ 1,600,000	$ 1,300,000
Current 401(k)	$ 40,000	$ 350,000
Deferred Compensation		$ 750,000
Total Retirement Savings	**$ 1,640,000**	**$ 2,400,000**
COMBINED TOTAL: $4,040,000		

This is a hypothetical example to illustrate Wealth Enhancement Group's methodology. Not reflective of any individual client's experience.

FINANCIAL PLANNING IS AN ONGOING PROCESS

As you might expect, Jackson and Michelle are plenty busy. Their jobs haven't given them time to do a deep dive into their financial plan. What's the best way to help with their children's college tuition? Will they be able to maintain their lifestyle in retirement? What will their tax situation look like once they retire?

Throughout their careers, the Hydes made sound financial decisions: making maximum contributions to their 401(k)s, investing in 529 plans for their daughters and saving in a Health Savings Account (HSA). Until recently, their financial plan was on autopilot.

While they've taken a number of steps to secure their futures, there are things they'd like to do now, like update their house.

Now they have all sorts of new considerations:

- They hope to fund a larger percentage of their daughters' education than their current 529 balance, and their daughters' college ambitions, will allow.
- They would love to complete their home improvement projects before they become empty-nesters, but aren't sure how to fund them.
- Both Jackson and Michelle have significant stock holdings in their current companies. Michelle has a large sum set aside in deferred compensation and with Jackson now considering a deferred compensation plan, they worry that too much of their wealth is linked to a couple of companies.
- And on top of everything, Jackson's raise will push them into a new tax bracket.

The Hydes have a lot of questions about leveraging the assets at their disposal to pay for the things they want now, while maintaining their lifestyle into retirement. Let's take a look at some of the Hydes' options for funding their near-term goals while keeping their retirement secure.

Funding needed for near-term goals

Michelle and Jackson figure that they need about $150,000 to do their home renovations this year. They have decided to contribute $25,000 per child per year starting next year to help with college costs for a total of about $350,000 over five years.

YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5	TOTAL AMOUNT NEEDED
Remodel	College	College	College	College	
$150,000	$50,000	$50,000	$50,000	$50,000	**$350,000**

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USING YOUR ASSETS IN A TAX-EFFICIENT MANNER

One option to fund their near-term goals is for Michelle to sell some of the stock from her previous company. While she was employed there, Michelle took advantage of company stock options and holds a substantial amount of company stock in her previous 401(k). The current value of that 401(k) is $1.3 million, of which $800,000 is appreciated company stock. When Michelle left her previous employer, she had four options for dealing with her 401(k):

OPTION 1	OPTION 2	OPTION 3	OPTION 4
Keep her money in her former employer's 401(k) plan	Roll over her account balance into her new employer's 401(k) plan	Roll over the account balance into a Traditional IRA	Cash out the account

When she left, Michelle chose Option 1. While she knew she had an over-concentrated stock position, she also had too much going on at the time to think through her options. Now that she's done some research, she knows that since she is 59½ she won't be subject to an early withdrawal penalty, so she thinks that using some of the funds in her old 401(k) might be a good option. That is, until they do the math.

If they take the money directly out of Michelle's previous 401(k) they'll also need to take out enough to cover the taxes. That means in order to access $350,000 of their capital, they need to take out almost $480,000.

TOTAL 401(K) WITHDRAWALS NEEDED TO FUND THEIR SHORT-TERM GOALS

	2023	2024	2025	2026	2027	
	Remodel	College	College	College	College	**TOTAL**
Amount Needed	$ 150,000	$ 50,000	$ 50,000	$ 50,000	$ 50,000	$350,000
Taxes*	$ 55,500	$ 18,500	$ 18,500	$ 18,500	$ 18,500	$ 129,500
TOTALS	**$ 205,500**	**$ 68,500**	**$ 68,500**	**$ 68,500**	**$ 68,500**	**$479,500**

*With Jackson's promotion the Hydes anticipate they'll be in the 37% tax bracket.

FORTUNATELY FOR THE HYDES, there is another option. It's a strategy that will allow Michelle to utilize her Net Unrealized Appreciation (NUA), to reduce taxes owed during retirement while helping to reduce their concentrated stock position.

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TAX-EFFICIENT STRATEGY: NET UNREALIZED APPRECIATION

What is Net Unrealized Appreciation?

NUA is the difference between your cost basis, the amount you paid for the stock ($300,000 in Michelle's case), and its current value. If you qualify for this strategy and if it's executed correctly, you can realize gains under capital gains rates, rather than the higher ordinary income tax rates that typically apply to tax-deferred accounts.

So when does it apply?
In order to take advantage of NUAs, the following must apply:

- NUA only applies to stocks you own in a company where you are, or were, an employee.
- You experience one of four triggering events: separation from employment, reaching age 59½, total disability or death.
- Stock must be distributed in-kind from the employer plan.
- Stocks must have been placed in a tax-deferred account when purchased.
- You must take a lump sum distribution of all assets from the 401(k) in the same calendar year.

How does it work?

Michelle reviewed the triggering events and discovered that since she hadn't made any withdrawals from her 401(k) since leaving her former employer, she qualified under the separation from service provision.

Once you determine that you qualify for an NUA, you need to decide whether you will use the NUA strategy on some, or all of your shares. NUA shares will be transferred directly into a brokerage account and you will owe taxes on those shares. You also need to decide what you want to do with the remaining balance of your account. Generally that means rolling it into a Traditional IRA and continuing to defer the taxes until retirement.

Let's start by looking at how the $800,000 worth of company shares will be taxed if left in her 401(k). Because the shares are in a tax-deferred account, she will be taxed at her ordinary income rate as the shares are withdrawn. At their current rate of 37% their tax bill would be $296,000!

If she used the NUA strategy on all $800,000 worth of stock, she would pay income tax on the cost basis ($300,000 at 37%) and the capital gains rate on the remaining value ($500,000 at 20%). Unfortunately, that still means a tax bill of $211,000.

Since the Hydes only need access to about $350,000 to fund their immediate goals, it doesn't make sense for them to use the NUA strategy on all of the eligible stock, especially since they're in a high tax bracket. Luckily, it is possible to use the NUA strategy on a portion of the stock. This will allow them to benefit from the lower capital gains rate now, and defer taxes on the rest by rolling it into a Traditional IRA.

Michelle and Jackson realize that this is quickly getting very complicated, so they defer the NUA discussion for now to consider other options.

STOCK AS COMPENSATION ADDS COMPLICATION

As a startup, Jackson's company wanted to maximize cash flow. But they also really wanted Jackson as CMO and wanted him to be as excited about the company's prospects as they were. As such, they offered him 5,000 Restricted Stock Units (RSUs) in 2021 vesting at 1,000 per year on May 1, beginning in 2023.

Both Jackson and Michelle had stock options at previous companies, so they figured they knew the drill. But they quickly learn that RSUs are very different than stock options.

STOCK OPTIONS give you the opportunity to purchase a set number of shares of company stock, at a specific price (grant price), during a specific window of time. *Whether you exercise the options is up to you.*

VS

RSUs grant you the right to receive the specified number of actual shares at the specified time. *With RSUs, no action is needed on your part to get the benefit, or the tax bill.* When RSU shares vest it creates a taxable event. And, because restricted stock is treated as supplemental wages, ordinary income tax rates apply.

As mentioned, Jackson has 1,000 RSUs scheduled to vest later this year. The current market price of the stock is $50. If that price holds, he'll owe taxes on an additional $50,000 worth of income when his 1,000 shares vest. At their 37% rate that's $18,500.

While not delighted by this news, Michelle and Jackson are glad they realized the implications of the RSUs with enough time to make a plan. On one hand, this might be another potential source for the extra cash they're looking for to cover their home remodel and college costs. On the other hand, they're facing yet another big tax bill and need to understand their options better—especially since they'll have shares vesting for the next five years.

Because you don't control when your RSUs vest, planning ahead is critical to maximizing this employee benefit. That means having a plan for how to pay the tax bill as well as when to sell your shares.

Know how you'll pay the tax bill before your RSUs vest

RSUs are taxed as ordinary income when they vest and may be subject to Social Security and Medicare tax in addition to state income tax. This section will only focus on federal income tax.

Up to now, the Hydes paid income tax through withholdings from their paycheck, and it's possible that when the RSUs vest, Jackson's employer will withhold some tax. Jackson needs to find out if his company will withhold taxes when the RSUs vest and if so, how much.

HOW TO PAY TAXES OWED WHEN RSUS VEST

There are several potential options you can take when RSUs vest and Jackson will want to find out which, if any, are available in his plan so he can be prepared.

NET EXERCISE	SELL-TO-COVER	CASH EXERCISE
A portion of the shares equivalent to the amount of taxes due are withheld by your employer and the remaining shares are delivered to you.	You immediately sell enough of the vested shares to cover the taxes due.	You pay your company the amount of cash required to cover the tax bill. This approach leaves you with the most shares.

SOMETIMES PEOPLE THINK that if they wait a year or more they can take advantage of long-term capital gains rates. But remember, a taxable event occurs when the RSUs vest, regardless of whether or not you sell. If you hold the stock for more than a year before you sell, then the capital gains rate applies, but only on any increase in value between when the stock vested and the date of the sale.

Decide whether you'll keep or sell your shares

With options for paying the tax bill, Jackson and Michelle need to decide if they want to sell their shares, and if so, how many and when. Some companies have minimum holding requirements for their executives, but Jackson's plan doesn't. That being said, the company has a bright future and he'd like to own a piece of it.

On the other hand, holding a concentrated stock position in a single company comes with a significant amount of risk. In fact—Michelle and Jackson have several sources of company risk in their portfolio:

1	Thanks to several strong years of growth, over 60% of the value of Michelle's former 401(k) is in company stock.
2	While not a stock position, Michelle does have $750,000 in deferred compensation with her current employer.
3	When fully vested, and assuming the stock price stays at $50, Jackson will have $250,000, plus any compensation he defers, tied to the success of his current employer.

While Jackson and Michelle are confident in the health of their current employers, seeing those numbers all lined up makes them more than a little nervous. Fortunately, there is one more option to consider.

BENEFITS OF DEFERRED COMPENSATION

Jackson was delighted that his hard work for his friend's startup had paid off, and that he was being compensated for his efforts. But the feel-good moment passed once he realized that his raise pushed their income into a higher tax bracket—$37,000 of his $100,000 raise would go to Uncle Sam. Michelle suggested he take advantage of his ability to defer up to 20% of his salary to lower their income.

There are two types of deferred compensation plans: qualified and non-qualified. Jackson's plan, like most, is non-qualified deferred compensation (NQDC), which we'll discuss here. Plans can vary widely, so before you participate in a deferred compensation plan you should consult with a tax specialist and consider how it will fit into your long-term plan.

As he looked into the details of his plan he saw that it differed from Michelle's plan, and most deferred compensation plans, in a significant way. His plan included an employer-guaranteed 3% rate of return. While Jackson might be able to get a better return in an investment account, he liked the fact that this offered a guaranteed return, and 3% would likely be enough to ward off inflation. Michelle also pointed out that they'll be in a lower tax bracket during retirement, meaning they'll be able to keep more of the money he earns if he chooses to defer.

When it comes to distribution options, Jackson's plan is fairly standard. Each year he elects to defer income he can also elect either a lump-sum or 10 installment option.

If Jackson deferred the 20% maximum allowed by his employer, the Hydes would lower their income by $80,000. In the 37% bracket, that means a tax savings of $29,600 each year. Depending on their situation, that may even be enough to get them back down to their previous tax bracket, increasing their savings even more.

On top of that, at the end of six years they will have reduced their taxes by $177,600 and his deferred compensation would be worth over $500,000. Sounds like a no-brainer, right? Not so fast.

AGE	DEFERRED AMOUNT	ENDING BALANCE*
59	$80,000	$82,400
60	$80,000	$167,272
61	$80,000	$254,690
62	$80,000	$344,730
63	$80,000	$437,473
64	$80,000	$532,997

*Calculation assumes full amount deferred at beginning of year, a 3% rate of return compounded annually.

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DRAWBACKS OF DEFERRED COMPENSATION

Often referred to as "golden handcuffs," NQDC plans are used to attract and retain top employees. These plans are golden because they provide an attractive income source upon retirement—and handcuffs because they typically include terms that create a disincentive for the employee to leave.

For example, you might forfeit any employer contributions to the deferred compensation if you leave to join a competitor. In some cases, separation prior to the agreed-upon date or due to job loss could trigger a lump sum distribution, causing a huge tax bill. Even if you don't leave the company, NQDCs come with fewer protections than are available with 401(k)s. For example, unlike 401(k)s, NQDC funds are not protected from creditors in bankruptcy.

NQDCs are also less flexible than other types of retirement accounts—you can't take out loans against them or roll them into an IRA. Generally, once you make your distribution election you can't change it. Even if your plan offers re-deferral elections there are generally strict rules about timing that must be followed. It's important to consult with an advisor experienced in deferred compensation plans, an attorney or a tax specialist before deciding to enroll.

In the Hydes' case they are maxing out their 401(k) contributions and are pretty confident that they will be in a lower tax bracket in retirement. They also feel good about the health of Jackson's company. The Hydes feel deferred compensation might be a good option, but they wonder if they should use the income for their short-term goals instead. Feeling like they have more questions than answers, Jackson and Michelle decide it's time to meet with a financial advisor.

NQDC payouts are subject to triggering events

A FIXED DATE DETERMINED BY THE EMPLOYER

SEPARATION FROM SERVICE

A CHANGE IN COMPANY OWNERSHIP

DEATH OR DISABILITY

UNFORESEEN EMERGENCY

TO DEFER OR NOT DEFER

Michelle and Jackson have a lot to consider before deciding whether or not to extend their participation in deferred compensation plans.

Here are some questions for anyone considering a deferred compensation plan:

1

Are you maximizing your traditional retirement plan contributions?

If the goal is to save for retirement while lowering this year's tax bill, the first step is to maximize annual retirement plan contributions. For 2023, the individual contribution limit for 401(k) plans is $22,500, plus catch-up contributions of $7,500 for those over 50.

2

Will you be in a lower tax bracket when the deferred compensation payments start?

If the answer is no, it might not make sense to defer without first considering funding other options like a backdoor Roth conversion or a Health Savings Account (HSA) that could provide tax-free growth.

3

Are you comfortable with the distribution options?

As we've discussed, distribution options can vary considerably by company so you need to understand and be comfortable with the options available to you, including re-deferral options and what happens if you leave the company before you retire.

4

What investment options are available in the plan?

Fixed-rate plans like Jackson's are less common than they used to be. Instead, most companies base growth off of stock or bond indexes. You'll want to consult with a financial advisor to help ensure proper diversification among your investments.

5

Is the company financially secure?

Deferred compensation plans are essentially an IOU from your employer, so you need to feel confident that they'll keep up their end of the bargain.

THE RIGHT PARTNER CAN HELP YOU NAVIGATE FINANCIAL COMPLEXITY

When Jackson and Michelle met with their advisor, Kate, for the first time, they were surprised at how much time was spent talking about their goals and values compared to their dollars and cents. In addition to discussing their near-term goals, they also discussed their plans for retirement. They know they want to travel, and they want to keep their relocation options open since they don't know where their children (and maybe future grandchildren) will live.

They walked Kate through their research and outlined their most pressing concerns, including:

- What, if anything, they should do with Michelle's previous 401(k)
- Whether or not Jackson should take advantage of the deferred compensation plan that is available to him
- How to best fit Jackson's RSUs into their financial plan

While Kate was impressed with the Hydes' research, she also understood why they felt stuck—they are dealing with many moving parts and each have implications for other parts of their plan. Kate offered to consult with colleagues who had different areas of expertise and come up with a plan for Jackson and Michelle.

THE HYDE'S FINANCIAL PLAN. CRAFTED WITH CARE.

When Jackson and Michelle met with Kate a couple weeks later, they started again by reviewing their short-term and long-term goals.

STEP ONE

Their short-term goals are to fund a home remodel in 2023 and contribute $25,000 per year to college tuition and fees for each of their daughters. Their long-term goal is to limit company risk in their portfolio through effective diversification while reducing their tax liability in retirement. With those goals in mind, Kate makes the following recommendations:

Address Michelle's 401(k) from her previous employer.
Michelle's previous 401(k) has a balance of $1.3 million with $800,000 in former company stock. The current stock price is $800 per share. As previously discussed, Michelle qualifies for the NUA strategy and Kate recommends that they apply NUA to the shares with the lowest cost per share, those purchased in 2015.

NUMBER OF SHARES	PURCHASED	COST PER SHARE	COST BASIS	CURRENT VALUE
300	2014	$300	$90,000	$240,000
400	2015	$250	$100,000	$320,000
300	2016	$367	$110,000	$240,000
1,000			**$300,000**	**$800,000**

By applying the NUA strategy on the lowest cost basis portion of her company stock, Michelle benefits from the lower capital gains rate and will have access to funds in a taxable brokerage account. And, by rolling the remaining 401(k) balance into a traditional IRA, she can continue to defer taxes until she's in a lower overall bracket.

Here's how it works. Michelle moves 400 shares of her previous company stock into a taxable brokerage account. Kate then recommends that they sell enough shares from the brokerage account to cover the $81,000 in taxes due. She's left with a balance of $239,000 in a taxable brokerage account. As they move forward with the remodel they can sell shares to cover the expenses.

CURRENT VALUE	COST BASIS	INCOME TAX (37%)	NUA	CAPITAL GAINS TAX (20%)	TOTAL TAXES PAID
$320,000	$100,000	$37,000	$220,000	$44,000	**$81,000**

The rest of her previous 401(k) will be rolled into a Traditional IRA and will be invested to align with Michelle's risk tolerance and timeline.

Using this strategy, they decreased the amount of company risk in their portfolio to just those currently in her taxable brokerage account. Additionally, by moving some of their assets from a tax-deferred 401(k) into a taxable brokerage account, they reduce their retirement tax liability and begin to build the tax diversification they'll need to have income flexibility in retirement.

THE HYDE'S FINANCIAL PLAN. CRAFTED WITH CARE.

STEP TWO

Sell the RSUs, at least this year.
While understanding Jackson's desire to keep some of his RSU shares, Kate points out the tight tax situation they are in this year and suggests they expand the "sell-to-cover" strategy to a "same-day-sale." When the stocks vest, Jackson will sell them at market price for $50,000, will pay the $18,500 in taxes and can use the remaining $31,500 to help fund their remodel project.

STEP THREE

Defer compensation, at least this year.
Jackson and Michelle will realize a lot of extra income this year.

KATE'S RECOMMENDATION: Between Jackson's raise, using the NUA strategy and Jackson's RSUs vesting later this year, Kate recommends that they defer as much income as possible this year.

For Jackson, this means using his deferred compensation plan and deferring $80,000 of his salary with a 10-year payout. Kate explains that if deferred compensation is paid out for fewer than 10 years (e.g. over five years or as a lump sum) it is taxed in the state where it was earned. This is true even if Jackson and Michelle decide to relocate in retirement. Choosing the 10-year option ensures that their deferred compensation will only be taxed in the state they reside in.

While this does reduce their income by $80,000, that doesn't quite get them to where they want to be. Which leads to Kate's next recommendation.

STEP FOUR

Bunch tax deductions, at least this year.
When reviewing Michelle and Jackson's financial records, Kate notices that there are several charities they give to regularly. After confirming that the Hydes will continue the contributions, she suggests that they use $100,000 in shares from the NUA transaction to set up a Donor Advised Fund (DAF). With a DAF, you get a tax deduction the year you make the contribution, but spread the charitable donations out over several years. By donating stock they can deduct the fair market value of the stock, up to 30% of their Adjusted Gross Income (AGI) and avoid capital gains tax by selling the stock within the DAF.

By bunching several years of charitable deductions into one year, combined with up to $10,000 in state and local tax deductions, the Hydes' itemized deductions of $110,000 far exceed the 2023 standard deduction of $27,700.

Between the income they deferred and their deduction "bunching" the Hydes will find themselves back in their previous 35% tax bracket while gaining access to funds needed to get started on their home remodel.

STEP FIVE

Finally, keep planning.
Kate explains that Jackson and Michelle's situation will be different next year. Tuition payments will kick in and they will want to revisit the decision of whether and how much compensation to defer and what to do about their RSUs.

YOUR COMPENSATION IS UNIQUE. YOUR PLAN SHOULD BE, TOO.

Having more kinds of compensation is great, but it can also complicate your financial life. Financial planning gets more complex as you accumulate wealth. The decisions get tougher. Income becomes more diverse. If your compensation plan includes non-cash compensation like RSUs, incentive or non-qualified stock options or deferred compensation, you can probably sympathize with Michelle and Jackson.

Remember, it's important to have a comprehensive understanding of your financial situation—including how the various parts work together. And managing this level of complexity in a financial plan requires an extraordinary level of care.

That's where Wealth Enhancement Group comes in. When you work with us, you'll benefit from the expertise of our Roundtable™ team of specialists. Unlike other RIAs, Wealth Enhancement Group goes to great lengths to understand your life goals so we can craft your personalized financial plan with the care you deserve.

Call us today at **1-888-842-6190** to schedule your free, no-obligation meeting.

In this no-obligation, introductory meeting, we will:

- Discuss where you are now and what you want to accomplish
- Identify opportunities for your portfolio and plan
- Provide proactive next steps to pursue your goals

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YOUR FINANCIAL PLAN, CRAFTED WITH CARE.

Wealth is personal, and it requires exceptional craft and care to fashion it into something truly all your own.

At Wealth Enhancement, we don't just manage portfolios or start with the same formulaic questions. We strive to unlock your wealth's full potential with teams of experienced professionals who take the time to understand your financial picture.

Starting with our 3-step UniFi™ process, we ensure every aspect of your financial life is organized, accounted for, and explained, giving you a comprehensive view of where you stand.

With our Roundtable™ of financial specialists, your advisor can provide comprehensive financial planning, retirement income planning, tax strategies, investment management, estate planning, and insurance.

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Organize.

We collect your financial information and consolidate it into your UniFi Inventory™.

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Our Roundtable™ team approach helps ensure your financial plan is comprehensive.

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Call us today at **1-888-842-6190** to learn more.

CALL US TODAY
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Schedule a free, no-obligation meeting to learn how our 3-step UniFi™ process simplifies your financial life.

(For best service, please call between 8:00 a.m. and 5:00 p.m. Central Time)

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