

### Incentive Compensation

### Incentive Compensation Typically Comes in Three Varieties

Type of Compensation	AMT Tax (26%-28%)	Income Tax (up to 37%)	Investment Tax (up to 20%)	Cash/Risk
<b>Incentive Stock Option</b>	When exercised	Sold within one year	Sold after one year	Strike price
<b>Non-Qualified Stock Option</b>	None	When issued	None	None
<b>Restricted Stock</b>	None	Sold within one year	Sold after one year	Price Paid

#### Terms Defined

**Vesting Date:** First date when options can be exercised

**Expiration Date:** Last date when options can be exercised

**Strike Price:** Price paid to exercise options

**Exercise:** Convert options plus cash into shares

#### Strategy

**Risk Management:** Working for company and owning shares combines career risk and financial risk

**Liquidity and Cash Flow:** Optimal timing of exercising options and selling shares

#### Example

Employee has incentive stock options to purchase 100 shares at \$5 per share every year for 10 years

##### Optimal Strategy

*Assumptions: Stock trades at \$10, and proceeds are after-investment tax of 20%<sup>1</sup>*  
 Immediate exercise and sale after one year generates \$4,000, or \$400 per year.  
 For every dollar the stock appreciates, the proceeds increase \$800, or \$80 per year.  
 The cash at risk is \$500, but if the stock doubles, the proceeds triple to \$12,000.

##### Alternative Strategy

*Assumptions: Stock trades at \$10, and proceeds are after-income tax of 40%<sup>2</sup>*  
 Immediate exercise and sale every year generates \$3,000, or \$300 per year.  
 No cash at risk, but this strategy is inferior unless the stock declines 12.5% or more.

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<sup>1</sup> Excluding state taxes and investment surtax of 3.8% for taxpayers with income exceeding \$250,000

<sup>2</sup> Doesn't include California income tax, which can be as high as 13.3% depending on income