

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
Incentive Stock Option	When exercised	Sold within one year	Sold after one year	Strike price
Non-Qualified Stock Option	None	When issued	None	None
Restricted Stock	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%¹
 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%²
 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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¹ Excluding state taxes and investment surtax of 3.8% for taxpayers with income exceeding \$250,000
² Doesn't include California income tax, which can be as high as 13.3% depending on income