Retaining and Rewarding Key Employees

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Overview

• Presentation will summarize basic techniques for designing special compensation programs for key employees, and explain the basic federal income tax consequences of those programs

• The summary assumes that the employer offering the compensation is privately held (i.e., does not have publicly traded securities subject to federal securities registration requirements)

• Note: ESOPs and unique issues involving S-corps and LLCs will not be addressed

Key Questions for Employers

• What are your compensation goals and compensation philosophy?

• Are you working within an important time frame or toward an important milestone?

• Who are your key employees?

• Are there real or perceived gaps in your compensation program for key employees?

• What external or internal parameters apply?

Cash Compensation and Its Limitations

• Cash is king, but current compensation . . .

  – doesn’t necessarily align key employee incentives with the company’s long or even mid-term goals

  – provides only a limited inducement to stay with company over extended period (element of “retention”)

• Discretionary bonuses provide a limited incentive because criteria are often unstated or too subjective

• Annual and long-term incentive plans that pay out in cash can and should be aligned with short and mid-term financial goals, but don’t necessarily induce employees to act more like owners.

• Annual incentive plans
– Tied to achievement of short term goals that are intended to be achieved within a single year
– Can combine company-wide financial goals with individual or divisional goals
– Paid out on an annual basis, typically at the beginning of the next year (ideally by March 15\textsuperscript{th})
– Best practice is to require employee to be employed on payment date

**Long-term incentive plans**
– Tied to longer term goals (3 to 5 year horizon)
– Paid out after end of performance period or after achievement of stated company goal(s)
– Can have successive or overlapping performance periods with evolving goals
– Some plans provide for payouts over future performance periods (to enhance retention)

**Equity-Based Compensation**

• Uses company stock, either directly or indirectly, to pay or measure incentive compensation or deferred compensation
• Common examples:
  – Stock bonuses
  – Restricted stock
  – Stock options
  – Phantom stock
• Can work with non-stock equity in most cases
• Can be structured to include element of retention
• Best limited to senior executives and key employees

**Some Basic Income Tax Rules**

• In general . . .
  – Cash compensation is taxed (and subject to wage withholding) in the year in which it is paid.
– A compensatory transfer of stock or other property is taxed the same as cash (i.e., as though the FMV of the stock were paid in cash).

– An employer can take a tax deduction for compensation for the same year in which the employee is taxed on the compensation.

• Special rules apply to . . .
  – “deferred compensation” arrangements, which pay compensation in the future for services performed by employees today; and
  – certain kinds of equity-based compensation, including stock options and restricted stock

• **Note**: FICA taxes may apply even where income tax does not, or may apply earlier than income tax

**Code Section 409A**

• Code Section 409A governs the income tax treatment of most deferred compensation arrangements

• Code Section 409A . . .
  – Provides a broad definition of nonqualified deferred compensation plan (subject to certain exceptions)
  – Establishes strict rules for deferral elections and benefit payment elections by employees
  – Imposes limits on the timing of benefit payments

• A plan provides for deferred compensation if a service provider obtains a *legally binding right* in one year to compensation which is or may be payable in a later year

• Three important exceptions under Section 409A:
  – **Short-term deferrals**: compensation paid no later than 2½ months after the end of the year in which amount is no longer subject to a substantial risk of forfeiture
  – **Stock rights**: fixed amount of company stock, exercise price equal to fair market value at grant, no deferral feature other than choice as to time or exercise and no modifications after grant
  – **Separation pay arrangements**: payments made on account of involuntary termination or termination for “good reason” that (i) do not exceed lesser of two-
Phantom Stock/Phantom Units

- A phantom stock program provides for a cash payment determined by reference to the appreciation in the value of the company’s stock over a period of time:
  - Employee receives 300 phantom shares when stock is worth $8.00 per share and will be eligible for pay out after 3 years; stock value on pay out date is $10.50; employee will receive a cash payment of $750 (300 X $2.50)
  - Can vest gradually or all at once or when the company achieves a certain financial goal
  - Employee is taxed at time of payment and phantom shares expire at the same time

Stock Bonuses

- Simplest form of equity-based compensation
- Treated the same as a cash bonus
  - Can be totally discretionary
  - FMV of stock is taxed in the year of award
  - Note that taxes must be withheld from employee’s cash compensation (or paid by employer)
- No element of retention
- No real “skin in the game” (other than tax payment)

Restricted Stock

- Same basic characteristics as stock bonus BUT the right to full ownership of the stock vests over time:
  - Award of 100 shares in 2011, with 25 shares vesting each year from 2012 through 2015 (“graded vesting”)
  - Award of 50 shares in 2011 all vesting in 2014 (“cliff vesting”)
- **Key:** employee must remain employed by the company in order to gain full ownership
- Can continue to apply certain transfer restrictions even after vesting of restricted stock
• Income tax applies in each vesting year based on the FMV of the stock that vests that year
  – Year 1: 25 shares vest and FMV of stock is $10, employee is taxed on $250 dollars of compensation income
  – Year 2: another 25 shares vest and FMV of stock is $14, employee is taxed on $350 of compensation income

• Employee can make a special election to accelerate taxation of full award in the year the award is made based on the FMV of the stock at that time
  – Good idea if stock value is initially low but expected to increase
  – See Code Section 83(b)

Stock Options

• A stock option is a right to purchase stock at a specified price (“exercise price”) either at or after a certain time

• Two kinds of compensatory stock options
  – Incentive stock options (ISOs)
  – Nonqualified stock options (NSOs)

• Optionee typically pays exercise price in cash, but can be paid in stock already owned

• Incentive stock options
  – Must meet specific tax code requirements, including requirements for shareholder approval
  – Exercise price must not be less than FMV of company stock as of grant date (and must be at least 110% of FMV if granted to a 10% shareholder)
  – Plan and options have limited lifespan
  – Can apply vesting requirements if desired
  – Favorable tax treatment: no income upon grant or exercise, and capital gain upon sale of stock

• Nonqualified stock options
  – NSO is an option that does not qualify as an ISO
– Code Section 409A essentially eliminated “in the money” NSOs so exercise price cannot be less than FMV of stock as of grant date

– Greater flexibility regarding lifespan

– Less favorable income tax treatment than ISOs

  • Employee has ordinary income upon exercise if FMV of stock is greater than exercise price

  • Employee has capital gain upon sale of stock if sale price is greater than exercise price plus income tax paid

Other Retention Arrangements

• Change in Control Agreements

  – Typically designed to retain services of key employees through sale of company, then pay out a separation or “golden parachute” benefit

• Separation Pay

  – Specifically designed to protect key employees in the event of termination without cause

  – Important requirements apply to avoid treatment as deferred compensation arrangement under Section 409A

• Supplemental Executive Retirement Plans