

# Incentive Compensation Arrangements: Attract, Motivate and Retain Key Employees

# Performance-Based Compensation

- Commissions
- Production pay
- Merit pay

## Equity-Based Compensation

- Stock
  - A corporate employer may grant an employee shares of stock as additional compensation either at a discount or for no consideration
  - Employee realizes ordinary compensation income equal to the FMV of the stock (less the amount, if any, paid by the employee)
  - Employer corporation receives a deduction equal to the amount taxed to the employee
  - Any appreciation after the grant date is taxed as capital gain at the time the employee sells the stock
  - Employer corporation does not receive a deduction for any amount taxed as capital gain to employee

# Equity-Based Compensation

- Stock Options
  - A contractual right that gives the employee the right to purchase a certain number of shares of the employer corporation's stock for a specified price
  - A stock option can be written to be exercisable at any time or within a certain period of time
  - An employee may be granted incentive stock options (ISOs) or nonqualified stock options (NSOs)

# Equity-Based Compensation

- ISOs
  - Employee receives actual shares of stock upon exercise
  - ISOs enjoy special treatment under the tax laws
    - Employee does not recognize income at the time of exercise
    - Employee recognizes income upon sale of the underlying stock
    - Income on the sale of underlying stock is treated as capital gain if employee holds the stock for at least 2 years from the date the options were granted and at least 1 year from the date the options were exercised
    - Employee is not subject to FICA taxes with respect to capital gain on the sale of the underlying stock
    - Employer corporation does not receive a deduction for the options granted to the employee or for the issuance of the underlying stock upon exercise of the option

# Equity-Based Compensation

- ISOs (continued)
  - Various requirements must be satisfied for options to be treated as ISOs, including:
    - The options must be granted to employees
    - The plan pursuant to which the options are granted must be approved by the shareholders within 12 months before or after the plan is adopted
    - The options must be granted within 10 years of the earlier of the plan's adoption or shareholder approval
    - The options must be exercisable within 10 years
    - The exercise price must equal or exceed the FMV of the underlying stock on the grant date

# Equity-Based Compensation

- NSOs
  - A NSO is a stock option that is not an ISO
  - Employee receives actual shares of stock upon exercise of the option
  - The options can have a vesting period over which the employee must remain employed
    - All or a portion of the options may vest on a date certain or upon the occurrence of one or more specified events
    - The options may vest ratably over a specified period of time

# Equity-Based Compensation

- NSOs (continued)
  - Exercise price is generally set at FMV of the underlying stock on the grant date
  - The grant of a NSO is nontaxable to the employee
    - Employee realizes ordinary compensation income on the date of exercise equal to the FMV of the stock less the exercise price
    - Any appreciation in the stock after the grant date is taxed as capital gain when the employee sells the stock
    - Employer corporation receives a deduction equal to the amount taxed as compensation income to the employee
    - Employer corporation receives no deduction for any amount taxed as capital gain to the employee

# Equity-Based Compensation

- NSOs (continued)
  - A NSO may provide for a cashless exercise (i.e., the option can be exercised without having to use cash to pay the exercise price)
  - The option may terminate on the earlier of some period of time after the grant date or within a certain period of time following termination of employment
  - Until the options are exercised, the employee does not have the right to vote, receive dividends, or receive information regarding the corporation

# Equity-Based Compensation

- **Restricted Stock**
  - Stock that is granted subject to various restrictions such as vesting and forfeiture
  - Stock certificates are held in escrow until the shares vest
  - The stock is generally forfeited if the employee fails to satisfy vesting requirements relating to service or upon other events such as the employee's termination for cause
  - Employee is considered a shareholder once the shares are vested
  - Employee generally realizes ordinary compensation income equal to FMV of the stock on the date the shares become substantially vested

# Equity-Based Compensation

- Restricted Stock (continued)
  - A Section 83(b) election may be made by the employee to immediately include the FMV of the stock on the grant date (less any amount paid)
  - If a Section 83(b) election is made, any appreciation in the FMV of the stock after the grant date is taxed as capital gain
  - The employer corporation receives a compensation deduction at the time the employee is taxed on the income
  - The employer corporation does not receive a deduction for any amount taxed as capital gain to the employee

# Equity-Based Compensation

- Phantom Stock
  - A promise from the employer corporation to make a cash payment to the employee based on the FMV of the corporation's stock
  - Merely a contractual right to receive a payment
    - Settled in cash
    - No actual stock is granted to the employee
    - Employee has no voting rights or other rights of a shareholder

# Equity-Based Compensation

- Phantom Stock (continued)
  - Employee is generally taxed as and when payments are received
  - The entire amount is taxed as ordinary compensation income
  - The employer corporation receives a deduction equal to the amount taxed as compensation income to the employee
  - No portion is taxed as capital gain to the employee
  - Must comply with Section 409A

## Equity-Based Compensation

- Stock Appreciation Rights (SARs)
  - Promise by the employer corporation to make a cash payment equal to the appreciation in the FMV of the corporation's stock over a specified exercise price
  - Equivalent to a stock option that is settled in cash upon exercise
  - Exercise price is typically equal to the FMV of the stock on the grant date
  - Employee is generally taxed as and when payments are received
  - Entire amount is taxed as ordinary compensation income to the employee
  - Employer corporation receives a compensation deduction equal to the amount taxed to the employee
  - Must comply with Section 409A

## Equity-Based Compensation

- Restricted Stock Units (RSUs)
  - Promise by the employer corporation to issue stock to the employee on the date of vesting of the RSU
  - Employee has no voting rights or other rights of a shareholder
  - Employee recognizes ordinary compensation income equal to the FMV of the stock
  - Any appreciation in the stock after the exercise of the RSU is taxed as capital gain to the employee
  - Employer corporation receives a deduction equal to the amount taxed as compensation income to the employee
  - Must comply with Section 409A

# Equity-Based Compensation

- Profits Interests
  - An equity interest in a partnership/LLC that gives the employee a share of future profits and equity appreciation in the company
  - A profits interest is generally nontaxable to the employee if the interest is held for at least 2 years
  - The employee becomes a “partner” for tax purposes
    - Employee’s share of partnership/LLC income is reported on a Schedule K-1
    - Employee’s salary treated as a “guaranteed payment”
  - The partnership/LLC does not receive a deduction

# Equity-Based Compensation

- Capital Interests

- An equity interest in a partnership/LLC that gives the employee, in addition to a share of future profits and equity appreciation in the company, a share of the company's existing value
- Employee recognizes ordinary compensation income equal to the FMV of the interest
- The partnership/LLC receives a deduction equal to the amount taxed to the employee

# Equity-Based Compensation

- Equity Options

- A contractual right that gives the employee the option to purchase a certain number of units in the partnership/LLC at a specified exercise price
- Grant or vesting of an equity option in a partnership/LLC is nontaxable to the employee
- Employee recognizes ordinary compensation income on the exercise of the equity option (if the equity interest is substantially vested) equal to the amount by which the value of the equity interest exceeds the exercise price
- The partnership/LLC receives a deduction equal to the amount taxed to the employee

# Equity-Based Compensation

- Equity Options (continued)
  - Upon exercise, employee becomes an equity owner with a capital account equal to the FMV of the equity interest
  - Employee is allocated a distributive share of the partnership/LLC's income and loss
  - Employee receives a Schedule K-1 from the partnership/LLC

# Equity-Based Compensation

- Restricted Profits Interests
  - Employee is treated as receiving the interest on the grant date
  - Employee immediately treated as a “partner” in the partnership/LLC
  - Employee is immediately allocated distributive share of partnership/LLC income and loss
  - No deduction is claimed by the partnership/LLC
  - Employee is not required to make a Section 83(b) election

# Equity-Based Compensation

- Restricted Capital Interests
  - Equity interest in a partnership/LLC that is nontransferable or subject to a substantial risk of forfeiture
  - Employee generally not taxed on the receipt of the interest until the restrictions lapse
  - Section 83(b) election may be made to treat the receipt of the interest as immediately taxable

# Equity-Based Compensation

- Phantom Equity

- A contractual right to receive a cash payment equal to the FMV of a unit of partnership/LLC equity upon the occurrence of one or more specified events
- Employee's status does not change for tax purposes
- Employee continues to receive a Form W-2 for wages, bonuses, and other compensation
- Employee is generally taxed as and when payments are received
- Entire amount is treated as ordinary compensation income
- The partnership/LLC receives a deduction at the time the employee is taxed on the income
- Must comply with Section 409A

# Equity-Based Compensation

- Equity Appreciation Rights
  - Contractual right to receive a cash payment from the partnership/LLC based on the appreciation in the value of the underlying equity in the company
  - Employee is generally taxed as and when payments are received
  - Entire amount is taxed as ordinary compensation income
  - The partnership/LLC receives a compensation deduction at the time the employee recognizes compensation income
  - Must comply with Section 409A

# Deferred Compensation

- Elective Deferral Arrangement
- Excess Benefit Plans

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