

Equity-based compensation can build loyalty while preserving cash

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There are many reasons why businesses turn to equity-based compensation plans. It can be a means of attracting and retaining key personnel when talent is scarce. In more troubled economic times, it can provide additional benefits and help cement loyalty and commitment without using precious cash.

Any business contemplating an equity compensation plan must think carefully about the strategic objectives it is trying to achieve before determining what type of plan to adopt. Key questions for business owners include:

Will this provide the necessary motivation?

How broadly does the plan need to apply?

How much of my equity do I need to make available?

Is there a better solution?

The choice of a plan will depend on the answers to these and many other questions. For most businesses, there are three main types of plans: stock options, restricted stock and phantom stock. The rules for each, especially the tax treatments, are very different.

A stock option plan involves the grant of an option to purchase stock in the company at the fair market value at the date the option is granted. Hopefully, if the company's value increases, the option can be exercised and the stock sold at a profit.

If the option qualifies as an "incentive stock option" (ISO) for IRS purposes, then there is no tax on the granting and no tax on exercise. In addition, if the option is exercised more than one year before the stock is sold and the sale occurs more than two years after the date of grant of the option, the profit will be taxed as a long-term capital gain.

All too often, holders of options never actually follow these rules and only exercise options and sell when there is a liquidity event. As a result, any gain they make is effectively taxed as ordinary income.

Notwithstanding, empirical data suggests that stock options do appear to be inherently motivational. In other words, the benefits accruing from the sense of ownership appear to be more important than maximizing the ultimate potential economic benefits.

The new deferred compensation rules that came into force in 2007 and that can require greater certainty as to the determination of fair market value for options that are not ISOs have had something of a chilling effect on the use of stock options, except in the most basic of situations.

In addition, accounting rules now require companies to determine the fair market value of options that vest during each year and show this as a compensation expense. This adds further cost and expense for businesses that need to produce GAAP-compliant financial statements.

As a result, restricted stock plans have become more popular. In this case, the employee actually receives stock in the company at the outset but must return all or part of the stock depending on the forfeiture conditions. In general terms, the tax rules provide more flexibility than the rules that now apply to stock options.

However, in contrast to the holder of an option, the participant will be a stockholder from the outset and will have all the rights commonly attributable to stockholders generally.

For some businesses, particularly S Corporations, this can be a problem. In addition, unless the price is discounted, the obligation to pay the fair market value for the stock at the outset may be more onerous than the ability to defer payment using options.

Phantom stock is not even stock at all. It is basically a bonus calculated as if the employee had been a stockholder in the company. At its most simple level, it is a bonus payable by reference to the value of the business on sale. Payments under the plan will be taxable as ordinary income and will be deductible for the business.

For most businesses, a plan that merely provides a bonus on sale will be a far simpler solution to implement than stock options or restricted stock. However, when the plan refers to a share of “net profits on sale” it is important that such a term is clearly defined.

Thus, the plan needs to cover relevant issues such as the treatment of carry back notes, earnouts, non-cash consideration (e.g., stock), holdbacks or other contingent payments in determining the amounts payable under the plan.

For limited liability companies (LLCs), stock options and restricted stock are not available solutions, although a phantom stock plan will work. LLCs are generally taxed as partnerships, not corporations, so the rules tend to be very different.

However, by using the concept of a “profits interest,” it is possible to grant an interest in the capital appreciation of the business and for the participant to get capital gains tax treatment on sale without payment of any tax either on grant of the interest or as it vests.

The choice of plan requires careful analysis of the overall business objectives as well as the various design permutations to ensure it meets the aspirations of all concerned.

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