

# Understanding equity compensation devices

How different equity compensation plans meet varying goals and situations

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Equity compensation compensates employees with payments tied to equity value. Because it ties compensation to the value of the company, it can be a great tool for incentivizing employees. Understanding the variety of equity compensation options available and the circumstances in which companies use them will help you make informed decisions regarding your compensation options.

## What is equity compensation?

Equity compensation is any of a variety of plans that tie a portion of certain employees' overall compensation to the value of the company. In most cases, equity compensation is provided only to key executives of a business and is provided

directly to the executives, in contrast to retirement plans that broadly benefit all employees and hold accounts on behalf of employees. By aligning compensation to the value of the company's equity rather than to a fixed dollar amount, these plans may provide additional motivation to executives to grow the business. The transfer of equity does not create a taxable sales event for the company's owners because equity is paid to plan participants as compensation rather than transferred to them via a sale. While many equity compensation plans dilute ownership in the company by transferring actual equity to employees, there are equity compensation programs that reward participants based on equity performance that do not transfer any ownership interest.

## When is equity compensation used?

Equity compensation may be used at different times in the business life cycle. Some start-up businesses use equity compensation to attract talented employees before the business has enough cash to compensate employees commensurate with competitors. For example, technology companies commonly provide stock options to all employees from the time the business begins to entice them to come work for the company and to bolster their current cash pay.

Other early-stage companies may have sufficient cash to pay competitive compensation without providing equity compensation. In these situations, companies may choose to wait until the business is more established and payments tied to equity have a more certain value. Mature companies may want to incentivize management by aligning a portion of their compensation directly with company performance.

Still other companies may find adequate ways to incentivize employees without introducing equity compensation until the founders begin to plan an exit from the business. At this stage, equity compensation can be a valuable way to align successors' interests with those of the company. Since those successors may not have been involved in the business from the beginning, equity compensation may be a way to mimic the founders' devotion to the company in the next generation of leaders.

## What types of equity compensation are available?

### Phantom stock

Phantom stock is one tool used to align compensation to company performance without transferring actual ownership to the employees. Phantom stock does not have voting or dividend rights, but the payment received by the employee is directly affected by the company's equity value. A typical phantom stock plan, for example, may provide that a certain executive receives a payment in three years that equals the value of 100 shares of the company's stock on that future date. The better the company performs and the higher the stock value on that date, the more money the executive receives. Although phantom stock uses stock value to measure the amount of the payment, the employee receives a cash payment that is taxed as ordinary income when received, and the employer reports a deduction in the same amount, with the timing of the deduction dependent upon when payment occurs.

### Stock appreciation rights

In contrast to phantom stock, which is tied to the full value of company shares, a stock appreciation right (SAR) provides a future payment based upon the stock's increase in value over a base amount. For example, a SAR may offer the employee a payment in three years that equals the number of SARs the employee holds times the difference between the stock price upon issuance of the SAR and the stock price on a specified future date. Because SARs provide less value per share than full-value phantom stock, companies typically provide an amount of SARs equal to three to four times the number of shares that would be associated with phantom stock. For this reason, SARs provide greater upside leverage than phantom stock. However,

unlike phantom stock, SARs do not provide any value to the employee should the value of the stock decline. As with phantom stock, the employee receives a cash payment that is taxed as ordinary income when received, and the employer reports a deduction in the same amount, with the timing of the deduction dependent upon when payment occurs.

An example may help you visualize how these plans work. Imagine a company president starts employment on July 1, 2014, when the corporation's stock value is \$100 per share. As part of his employment agreement, he receives a phantom stock grant that will pay him an amount equivalent to the value of 500 shares on July 1, 2017. If the stock price stays steady, he will receive \$50,000 in 2017. If the stock price declines, he will receive something less than \$50,000. On the other hand, if the stock appreciates 50 percent to \$150 per share, he will receive \$75,000. Now assume that instead of a phantom stock grant, the president on July 1, 2014, receives 2,000 SARs at the base price of \$100 that will be paid to him on July 1, 2017. If the stock price on July 1, 2017, is less than or equal to \$100, he will receive no payment from the SARs. However, if the stock price is \$150, he will receive 2,000 shares times the \$50 increase, or \$100,000. Thus, the SARs are more motivating to the president because they provide greater upside if the company stock performs very well, plus the risk of receiving nothing if the stock goes down in value creates greater incentive to increase the company's value.

### Company stock

Part of an executive's compensation package may include payment in company stock that is vested upon transfer to the executive. Payment in company stock may be valuable as it makes the executive a direct owner with voting and other ownership rights, depending upon the class of stock transferred. Not only does this align the employee's interests with those of shareholders, it does so without a current cash cost to the company (other than income and payroll taxes that need to be withheld and remitted to the IRS). In the year of transfer, the employee reports ordinary income equal to the value of the stock received over the amount the employee pays for the stock. The company deducts the same amount according to its normal method of accounting for tax purposes (cash or accrual).

### Restricted stock

When employees are paid restricted stock, they are given actual company shares with some restriction placed on them, just as the name implies. The restrictions must generally be related to the performance of future services. For example, the stock may be granted to the employee in 2014 but not vest until 2017. Thus, the employee must still be employed by the company three years later to possess a vested right in the shares. Because of the conditions associated with restricted stock, employees have a risk of forfeiture until the conditions are satisfied. As long as such risk is considered substantial

under the tax rules governing stock compensation, the employee will not be taxed until the conditions are satisfied and the employee is vested in the stock. Upon vesting, the value of the restricted stock is taxed as ordinary income to the employee on that date, and the employer receives a corresponding deduction in its tax year in which the employee recognizes the income.

A special tax rule exists that allows employees to elect to include the value of unvested stock that has been transferred to them in their taxable income upon grant, rather than in the future when it vests. If the election is made, the employer also gets the deduction in that year of grant. The benefit of the election is that the employee reports less ordinary income in the event the stock appreciates during the vesting period. When deciding whether to make the election, the employee needs to weigh a number of factors, including the risk of forfeiture, the likelihood of the stock appreciating during the vesting period, and current and future tax rates. The tax election (referred to as an 83(b) election based on the governing tax code section) must be filed with the IRS within 30 days from the date of receipt of the restricted stock.

One variation of restricted stock is a restricted stock unit (RSU), which does not actually transfer stock to the employee until the associated vesting conditions have been satisfied. Therefore, a similar effect of incentivizing the employee is achieved, but with a promise to transfer property in the future instead of currently. With an RSU, the 83(b) election is not available to the employee. Instead, the recognition of income by the employee and the employer deduction occur in the future when the conditions are satisfied and the stock is transferred.

### Incentive stock options

A stock option grants an employee an option to purchase a specified number of employer shares at a specified strike price within a given time frame. Therefore, the employee benefits if the company's stock price rises over the strike price because he or she can buy at the lower strike price and sell at the higher future price. When an employee exercises a stock option, the employee becomes the legal owner of the stock on that date. Incentive stock options must meet a number of requirements in the tax code in order to qualify as incentive stock options. The requirements include restrictions on who can receive the options, when the options can be exercised, and the price at which the options must be exercised, among others. If the requirements are met, the employer receives no tax deduction, and the employee is not taxed upon grant or exercise. Instead, the employee is taxed when the stock is sold. Any gain on the sale is treated as capital gains income provided the stock is held for at least two years from the date of grant and one year from the date of exercise. If sold sooner, the gain is treated as ordinary income. It should be noted, though, that the difference between the exercise price and the FMV of the stock at the time of exercise (i.e., the value spread) is an adjustment for alternative minimum tax (AMT) purposes and could cause the employee to become subject to the AMT even though exercise is not taxable for regular tax purposes.

### Nonqualified stock options

Any stock option that does not meet the requirements to qualify as an incentive stock option is treated as a nonqualified stock option. The tax consequence is that the employee is generally taxed upon exercise of the option on the difference between the strike price and the fair market value on that date. The gain is treated as ordinary income. When the employee recognizes income upon exercise, the employer receives a corresponding compensation deduction. This result assumes the option does not have a readily available fair market value. If the option has a readily available fair market value, which is rare, employees are taxed upon grant rather than upon exercise.

There are advantages and disadvantages to both incentive stock options and nonqualified stock options. Incentive stock options are more restrictive but can be more tax-beneficial to employees. Nonqualified options provide much more flexibility and are generally more tax-favorable to the employer.

### Stock bonus and employee stock purchase plans

In general, with a stock bonus plan, the employer sets up a defined contribution plan to which it makes discretionary contributions of company stock. The plan is a qualified retirement plan and must meet the various requirements applicable to retirement plans, including covering most employees. However, a stock bonus plan that is not an employee stock ownership plan (ESOP) does not have the additional requirement of being primarily invested in employer stock. Taxation of a stock bonus plan is the same as with other qualified retirement plans. The employer receives a tax deduction at the time of contribution, and the employee recognizes ordinary income in the amount of the distribution as distributions are received.

Rather than the company contributing shares to the plan, an employee stock purchase plan (ESPP) allows employees the option to purchase company stock with after-tax dollars. ESPPs that meet certain requirements and offer broad employee participation will be qualified ESPPs that may allow employees to purchase shares at a discount of up to 15 percent off the fair market value and provide special tax benefits. An ESPP somewhat resembles a stock option plan but is generally for a broader group of participants. The employee generally does not pay income tax until the stock is sold, similar to the tax treatment of any other stock investment an individual might make. Gains, other than those related to the purchase price discount, are generally eligible for capital gain treatment.

### What about partnerships, which do not have stock?

Partnerships can mimic compensation methods that do not provide actual ownership. For example, a partnership can have a plan similar to a SAR plan that references partnership equity value rather than stock price. The payments are ultimately made in cash, not equity, so the plans for partnerships use different terms but otherwise work virtually the same as a similar corporate plan. The reporting may be slightly different since partners are not employees. Thus, to the extent an executive receiving rights under such a plan is a partner,

his or her payment may be treated as a guaranteed payment rather than wages. For payments that provide actual equity rather than cash tied to equity value, a partnership can use profits or capital interests.

### Profits interests and capital interests

A profits interest provides the holder the right to share in the future profits of the business. To compete for talent with corporations that can give management stock options, many partnerships use profits interests as a form of equity compensation for key executives. If certain facts are present, a safe harbor allows a profits interest to be treated as having zero value on the date of grant, which means that the partner does not pay any tax upon the receipt of the interest and the partnership does not receive a deduction. Under current laws, the sale of a profits interest will normally result in capital gain or loss treatment, with some exceptions.

A capital interest differs from a profits interest in that a capital interest shares in the rights to the partnership's assets on the date of grant, rather than only future appreciation. Unlike a profits interest, a capital interest has current value. Thus, it is a taxable event to the person receiving it if the value of the capital interest exceeds what he or she paid for it. Under current laws, the sale of a capital interest will normally result in capital gain or loss treatment, with some exceptions.

### What are the considerations when implementing an equity compensation plan?

The optimal equity compensation plan depends on the employer's goals. The type of plan may be dictated in part by which employees must be covered. In addition, different types of plans may lead to greater employee incentive to grow the business. An employer may have multiple equity compensation plans at the same time, and possibly separate plans for different levels of executives. Equity compensation may also be an important tool in planning for successor management during ownership transitions. Because many closely held business owners are also in high-level management positions at their businesses, finding competent successor managers when current owners want to reduce their time commitment to the business can be critical. Equity compensation can be a powerful tool in incentivizing key executives to continue their employment at the company and to make decisions that propel the company's success.

While most stock bonus and stock purchase plans are designed as qualified retirement plans, other forms of equity compensation are not. Therefore, employers need to be aware of section 409A, which provides rules on the deferral of compensation, and its application to equity compensation plans. The regulations under section 409A generally provide exceptions for certain equity compensation arrangements, including stock options and SARs. However, the exceptions need to be carefully considered at the time the plans are drafted to ensure all of the requirements are met and no unintended tax consequences occur.

One requirement in the section 409A exceptions involves a comparison of the exercise price of options and SARs to the fair market value of the stock on the grant date. If equity compensation is issued at fair market value on the grant date, there likely is no deferred compensation because the employee must pay an amount equal to the value and no deferred benefits are received. In a closely held business, this reference to fair market value requires careful consideration. The section 409A regulations provide that stock that is not traded on a readily established securities market must have value determined based on the reasonable application of a reasonable valuation method. While multiple valuation methods could meet this requirement, an independent, professional, third-party appraisal completed no more than 12 months before the compensation is awarded is presumed to be reasonable in most cases. This valuation requirement and other section 409A rules need to be considered concurrently when offering equity compensation in closely held businesses. The rules should not prevent implementation of certain plans, but the consequences of failure to comply are immediate taxation to the participants as the compensation vests, as well as significant penalties imposed primarily on the participant. Penalties to the employer can result as well, and employers need to ensure plans are designed and operated in compliance with section 409A.

### Conclusion

Employers at various stages of a business life cycle may benefit from adding equity compensation plans. Various equity compensation methods can provide great incentives to both employees receiving them and the employer providing them through increased engagement that can boost company performance. The type of equity compensation that will fit a given situation will vary depending on the employer's goals and the applicable facts and circumstances. Careful consideration should be given to choosing the appropriate type of compensation and complying with any applicable rules so that both parties can appropriately benefit.

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