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A LIMITED LIABILITY PARTNERSHIP

Incentive Compensation: Options
(and other alternatives)

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It is important to align the benefit with the desired incentive.

Having recognized that your idea to grant stock to your employees carries the unintended consequence of giving your employees a tax bill without additional funds to pay it, what options are there to compensate your employees in a similar fashion but without the bad consequences? There are many options, and options are one of them.

The five primary forms that incentive compensation can take are: stock grants, profit sharing, options, phantom stock, and a restricted stock sale. These alternatives are not exhaustive, and they can be used on a stand-alone basis or combined with each other or with more esoteric concepts. But these structures form the core building blocks from which one can develop a usable plan.

I will use the term *stock* while explaining these concepts, but keep in mind that *stock* is really a corporate concept. If your company is a limited liability company instead of a corporation, those *stock* rights might be called something else depending on the laws of the state where the LLC is formed and the terminology used in the

LLC's operating agreement or limited liability company agreement. Regardless, the concept is the same — we're talking about ownership rights.

Since I already addressed the first structure, stock grants, in my prior article, let's see how the other alternatives work.

Option 1: Profit Sharing

Profit sharing – the employees benefit whenever the business bears fruit.

The company could pay employees a bonus based on a percentage of the business's profits. Payments are often made annually during the first quarter based on the prior year's profits, but any frequency can be used. Just keep in mind that if you use something other than annual payments, the cyclical nature of your business can cause you to pay out more in profits than you intended if, for example, you had one profitable quarter followed by 3 unprofitable quarters. As for what percentage to pay, it can be a fixed or variable, and it can be vary over time or by person. For example, you may decide that 15% of the net profits will be distributed equally among all employees — as employees are added to the group, each employee gets a smaller share of the net profits. You may also decide to give a different percentage to different employees, such as taking the 15% and giving 3% to Employee A, 4% to Employee B, 3% to Employee C, and 5% to Employee D. You may even set a vesting schedule. For example, Employee A may have a 2% profit share in year 1, 3% in year 2, and 5% in year 4 to provide greater incentive to continue employment. Like the stock grant scenario, profit sharing creates an immediate ordinary income tax obligation for the recipient. But unlike the stock grant scenario, there is a matching of cash receipt with the tax obligation, so the employee does not have to use his or her "normal" salary to pay the expense. This also allows business owners to give their employees a "piece of the action" without diluting the voting rights of the existing shareholders.

Option 2: Stock Options

The company could grant options to the employees, which allows the employees to purchase stock in the company at a given price. The key variables are: (a) number of shares that may be purchased, (b) the price that must be paid to acquire each share, and (c) the

time limit by which the option must be exercised before it expires. For example, a business could grant Employee A the option during the next 10 years to purchase 100 shares of stock at $100 per share.

There are two basic types of stock option plans: statutory or incentive stock options ("ISOs"), which must follow strict requirements under the Internal Revenue Code, and non-statutory stock option plans ("NSOs"), which must not. Although the tax consequences of NSOs are not as favorable as those of ISOs, an ISO may not be appropriate in given situations. An ISO plan must name the class of employees that are eligible for options, thus making it an inappropriate vehicle if you intend to give options to only certain employees. Also, unless higher exercise prices and shorter option periods are applied, an employee cannot have ISOs that give him or her more than 10% of the voting power of stock unless the option exercise price is at least 110% of the fair market value. NSOs on the other hand are not subject to these types of restrictions.

ISO vs. NSO – it is not always clear which door to walk through.

With an NSO, the employee is taxed either at the time that the option is granted or at the time the option is exercised. If the option has a readily ascertainable fair market value and is not subject to a substantial risk of forfeiture, then it is taxed when it is granted (the employee therefore recognizes income equal to the value of the option, much like the problem if they were granted stock). If it has either of those qualities, then the option is not taxed until it is exercised. In that case, the employee will recognize income equal to the difference between the fair market value of the stock as of the date of exercise and the exercise price of the option. Of course, as with the stock grants, the employee can make an 83(b) election as I mentioned in the last article so that he or she will recognize income at the time of the grant and therefore secure capital gains treatment later.

Overall, though, stock options and how they are treated from a tax perspective can get very complicated. And the ability to obtain any intended tax benefits becomes even more complex if the employee can exercise the option at less than fair market value. But options are nevertheless a useful tool in many situations.

Option 3: Phantom Stock

Phantom stock need not be as mysterious as it first seems.

The company could give employees certain rights ("phantom stock") that are designed to give them a financial stake in the company as if they owned stock. Phantom stock plans can take a wide variety of forms, which enable them to be customized to the specific needs of the company. For example, in a ***dividend award***, the employee is awarded a certain number of phantom stock shares. Thereafter, the employee is credited with an annual payment on each share equal to whatever dividend was actually paid to the company's real shareholders. Distributions of amounts credited to the employee may be made in a lump-sum payment or in installments. In a ***phantom stock unit award***, phantom stock units may be issued on an annual basis if the company's earnings or profits equal or exceed predetermined target amounts. When earnings or profits fall short of the target, employees holding phantom stock units from prior years may still get "dividend" payments on those units, but they do not receive any new units. Also, under some plans, the amount of phantom stock awarded varies with company earnings or profits and is determined by a formula. The employee can also be credited with an increase in value of the company's stock. At a future date, the employee is entitled to "resell" such "phantom stock" back to the company, receiving the difference between the value of the stock on the date of the phantom grant and the value of such stock on the date of resale. As an alternative, some plans provide ***conversion rights*** that enable the employee to convert all or a portion of the phantom stock into actual stock. In such cases, the value of the stock at the initial grant date is either paid by the employee or awarded by the company as a stock award. Payments under a phantom stock plan may also be based solely on future appreciation, in which case the plan is basically a ***stock appreciation right*** (SAR) plan.

In any case, payouts received by an employee under a phantom stock plan are treated the same way as any other form of cash compensation, and the employee will recognize ordinary income in an amount equal to the payout. Of course, determining how to measure the phantom stock appreciation becomes essential. Many companies want to avoid the cost of regular business appraisals (which can easily cost $10,000-$20,000 each), so some form of

acceptable formula (perhaps based on gross or net revenues, EBITDA, etc.) needs to be found.

Option 4: Restricted Stock Sale

A business could allow employees to purchase shares under a restricted stock purchase arrangement. For example, a business could enter into an agreement whereby Employee A would purchase 100 shares for $1.00 per share. The shares would be subject to transferability restrictions and a substantial risk of forfeiture, and the restrictions would lapse upon certain milestones such as completion of a specified period of employment, retirement, or satisfaction of certain performance goals. During the restriction period, the employee usually has full ownership of the shares, including the right to vote and receive dividends that are distributed. The shares could also be in escrow until the restrictions lapse, thus helping to ensure that the certificates would be available should the business repurchase the shares upon termination of the employee's employment before the restrictions lapse.

Restrictions can be both necessary and good.

Without the transfer restrictions, the employees who enter into these agreements would recognize ordinary income at the time the shares are transferred equal to the difference between the fair market value of the shares on the date of transfer and the price they each paid for the shares (thus, if an employee pays full market value, he or she does not recognize income, but if $0 were paid, then it has similar problems as stock grants). Having transfer restrictions allows the tax to be deferred until the shares become transferable or are no longer subject to a risk of forfeiture. And unless the employee makes an 83(b) election, the employee will have ordinary income on the date the restrictions lapse equal to the difference between the value of the shares on that date and the purchase price. Afterwards, any increase or decrease in the shares upon sale will be capital gains or loss.

Quick Comparison

With that basic understanding about how the various plans work, let me compare some of the key elements of each option to help illustrate the issues. The following assumes that each employee has

a 35% marginal tax rate, and I am using an arbitrary $1,000 figure to provide a basis for comparing the plans.

A Comparison of Plan Types and Effects	
Stock Grant	If there are no transfer restrictions or substantial risk of forfeiture, employee pays $350 of tax on each $1,000 of stock granted, but no additional cash is received from which to pay this tax.
	If there are transfer restrictions or a substantial risk of forfeiture, then the employee does not pay tax when the stock is granted (absent the 83(b) election). But he or she incurs the tax whenever the restrictions lapse, again with no additional cash received from which to pay the tax.
	If there are no transfer restrictions or substantial risk of forfeiture, employee pays $350 of tax on each $1,000 of stock granted, but no additional cash is received from which to pay this tax.
	Once stock grants vest, the employee may have to pay tax without receiving cash to pay it.
Profit Sharing	Employee pays $350 of tax on each $1,000 of profits received, netting $650. Business also incurs additional payroll expenses.
NSOs *(If there are no transfer restrictions)*	The value of the option is taxable income when granted (with attendant payroll expenses for the business).
	The value equals the fair market value of the underlying stock (on the grant date) less the exercise price.
	Assuming a $10 exercise price, the employee must pay $346 of tax on each option to acquire stock worth $1,000.

A Comparison of Plan Types and Effects

	The upfront tax impact can be decreased by making the exercise price equal to the $1,000 fair market value of the underlying stock. But this increases the employee's future cash outlay to acquire the stock.
NSOs *(If there are transfer restrictions)*	The value of the option is taxable income when exercised (absent an 83(b) election) – the tax is the same as above other than (a) the timing of when the tax is incurred, and (b) the potential for higher income, and thus higher tax, due to the increase in the company's fair market value from grant date to exercise date.
NSOs *(In either case)*	Neither the options nor the stock obtained on exercise provide cash from which to pay the income tax.
	The exercise price may be a cash burden on the employee.
	The plan could provide for a cash-out feature, where the option is exercised and the stock is immediately redeemed by the company. This eliminates the need for the employee to pay the exercise price, and it provides the employee cash to pay the tax. But this is obtained at the price of not having stock that may appreciate in value.
Phantom Stock	The employee must pay $350 of tax on each $1,000 bonus received that matches dividends paid to shareholders, netting $650. Company also incurs additional payroll expenses.
	The employee must pay $350 of tax on each $1,000 received for each $1,000 increase in the phantom stock due to the company's increased value, netting $650. Company also incurs additional payroll expenses.

A Comparison of Plan Types and Effects

	No risk of tax without receiving cash to pay it (unless the phantom stock is convertible into real stock).
Restricted Stock Sale	Assuming a fair market value sale of $1,000 per share and that employee pays $1,000 for each share, there is no income recognized (and thus no tax paid) upon acquisition.
	The employee receives and pays taxes on $1 of income (without receiving cash) for each $1 reduction of the purchase price from $1,000. Company also incurs additional payroll tax. These taxes are deferred while the transfer restrictions and substantial risk of forfeiture continue.
	If the business is a "pass through" entity (e.g., an S-corporation or an LLC taxed as a partnership or S-corporation), then once stock is owned, there is risk of ordinary income tax without the cash to pay it because the employee is imputed with a pro-rata share of company's net income regardless of whether distributions are paid.
	When employee sells stock, he or she will have a capital gain or loss depending on the difference between the sale price and his initial purchase price (whether $1,000 or less).

There are a lot of variables that can affect the outcome of any chosen plan structure, including different plan details and changes in the business and industry environment. The above examples are not intended to be a guaranty of results but merely a tool to compare different plan structures in a static environment.

Hopefully, this information will give you a basic understanding of the alternatives so that you can better understand your particular details and concerns when discussing incentive plan alternatives

with your legal and tax advisors. The goal is to provide the incentives you want without the consequences you don't.

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