V. Equity Based Compensation For Small Business

A. Introduction

Equity-based compensation is a separate and distinct form of compensation from qualified retirement plans, with the one overlap of Employee Stock Ownership Plans (ESOPs) (and Profit Sharing Plans holding employer securities). This outline does not devote significant attention to ESOPs. The discussion focuses on equity-based compensation outside the ESOP, qualified plan context.

B. Why Use Equity-Based Compensation?

Reasons include (a) employee performance incentives for future performance, (b) attracting desired personnel, (c) rewarding past excellent performance, (d) selectivity in equity-based compensation and in substitution of "market" salary in cash starved "start-up" companies.

COMMENT: Equity-based compensation generally (with some exceptions) can be selective. IRC § 410 coverage rules do not apply (unless, of course, an ESOP or Profit Sharing Plan involved).

C. Unrestricted Stock Transfers

The simplest form of equity based compensation is to give an employee unrestricted stock. The corporation simply gives the employee unrestricted stock as compensation. This is often done under the mistaken understanding the transfer is not taxable. The fair market value of stock is taxable to the employee as ordinary income, subject to FICA and withholding. Fair-market value is subject to applicable minority, lack of marketability discounts. The employer is entitled to a corresponding deduction equal to the income recognized by the employee.

Good Questions – (1) What if the employer's principal shareholder gives stock to the employee as compensation? The IRS treats this as a contribution to the employer's capital, with the employer being deemed to transfer the shares thereafter. (2) Can the transfer ever be a nontaxable to gift (i.e., not taxable to the employee, nor deducted by the employer)?

Caution - Unrestricted stock can be just that, i.e., consideration should be given to conditioning the stock transfer on assent to a shareholders' agreement.

Securities Law Considerations

See the discussion under Restricted Stock.

D. Restricted Stock

General Considerations

Restricted Stock typically is provided by an issuer of common stock in connection with the performance of services. Restricted Stock, or units representing the stock, may be issued without cost or for a nominal price, and typically is subject to restrictions (i.e., the right to ownership will vest over a period of time and is nontransferable). Vesting rights also can be based on performance. The holder is viewed as the owner during the restricted period and is entitled to all rights as a shareholder for such stock.

Tax Consequences

When stock is transferred in connection with the performance of services, holders must include as ordinary income the excess of the fair market value of the stock over the amount paid for the stock. However if the stock is restricted (i.e., subject to substantial risk or forfeiture and nontransferable), the recognition of income is delayed until the restrictions lapse. Despite the restricted nature, holders may make a “Section 83(b)” election to include in ordinary income the excess of the fair market value of the stock over the purchase price at the date of grant; any subsequent gain would be taxed as capital gain.

Issuers are allowed a corresponding deduction equal to the amount included as ordinary income by the holder, provided the employer provides a timely W-2 or 1099, as appropriate (Reg. § 1.83-6(a)(2)). Employers are not required to deduct and withhold income tax as a condition of claiming the deduction (T.D. 8599, July 18, 1995).

Securities Law Considerations

The anti-fraud provisions of the federal and state securities laws will apply to the offer and sale of restricted stock. For federal purposes, the grant of restricted stock without cost typically is not considered to be a “sale” of or an “offer to sell” a security requiring registration; however, the sale of such stock for even a nominal cost may require registration or an exemption therefrom. In this regard, it is possible that a restricted stock plan may qualify for certain “private offering” exemptions. State blue sky laws may impose different qualification requirements or exemption standards (for example, California deems the grant of restricted stock without cost to be a “sale” requiring qualification or exemption).

E. Phantom Stock

General Considerations

Phantom stock typically is issued in the form of units which are equivalent to, but not actual shares of issuer's stock. The value of phantom stock equals the appreciation in the market value of the underlying stock between the date the unit is granted and its settlement date. Settlement usually occurs at retirement, termination of employment, or some other fixed date. The award may be payable in a lump sum or in installments in case stock or a combination of the two. A phantom stock plan often is used when it is not beneficial or possible to issue stock of the company to executives. Phantom stock plans typically differ from stock appreciation right (SAR) plans in that dividend equivalents usually are paid and phantom stock usually has a fixed settlement date.

Tax Consequences

No income is recognized at the time of grant, rather the units are taxed at the settlement date. Stock settlements are taxed at the stock's fair market value unless the stock is nontransferable and subject to a substantial risk of forfeiture. When the restrictions lapse, the difference between the fair market value of the stock and the holder's purchase price, if any, would be taxable. The holder must pay tax at ordinary income rates. Cash or stock awards are subject to withholding.

The employer is entitled to a deduction for phantom stock payments in the year the payments are made.

Securities Law Considerations

Similar to SAR treatment. Please refer to the section entitled "Securities Law Considerations" included with the summary outline on SARs.

Tandem Grants with NQSOs

By issuing tandem awards of phantom stock and non-qualified stock options (NSQOs), an employee can provide executives with both "stable" compensation in the form of phantom shares and "speculative" compensation in the form of at-the-money NQSOs. For example, to compensate an executive in the amount of $50,000, an employer can grant 2,000 shares of phantom stock (with "real" stock trading at $25) and NQSOs exercisable for 7,000 shares of stock at $25 per share (granted in tandem so that if one form of compensation is exercised, a pro rata amount of the other form is fortified). If the stock stays close to $25 per share, the executives can elect to receive compensation in the form of phantom shares. Alternatively, if the stock exceeds $35.00 per share, an exercise of the NQSOs would "leverage" the executive's compensation to a substantially higher level.

F. Non-Qualified Stock Options

General Considerations

Non-Qualified Stock Options ("NQSOs") entitle holders to purchase shares of an issuer's stock, or that of a parent or subsidiary, during a specified period of time and for a fixed price, thus providing performance-based compensation. Holders of NQSOs must recognize income upon exercises of NSQOs unless restricted stock is received upon such exercises. This treatment differs from the treatment attributable to an incentive stock option ("ISO") under which income may be deferred until a sale of the stock acquired.

The employer is entitled to a corresponding deduction equal to the income recognized by the holder of the NSQO (even where the employer's parent or subsidiary is the issuer). Based on the current federal income tax rates and the capital gain tax rate, it is generally preferable, from an overall economic standpoint, to use an NSQO as opposed to an ISO.

Unlike ISOs, NSQOs can be granted "in the money." "In the money" NSQOs, however, are now subject to the strict new rules applying to Nonqualified Deferred Compensation. NSQO holders are not subject to holding period requirements, NQSOs can be granted individually (rather than pursuant to a "plan"), and holders do not have to be employees (e.g., holders can be nonemployee directors or consultants).

NQSO holders may effect a "cashless" exercise whereby proceeds from a sale of underlying stock being acquired, or shares previously acquired, are used to pay the exercise price. NQSOs also may include a "reload" feature pursuant to which the issuer immediately grants the holder a new NQSO if issuer shares are surrendered to exercise the NQSO.

Tax Consequences

The grant of an NQSO typically is not a taxable event to the holder unless the option has a "readily ascertainable fair market value" (e.g., an exchange-traded option). A holder generally recognizes ordinary income as compensation for services upon the exercise of an NQSO equal to the excess of the fair market value of the underlying stock over the exercise price; however, if the underlying stock remains restricted, the recognition of the ordinary income will be deferred until the lapse of the restriction. A holder's sale of the underlying common stock is taxable as capital gain or loss based upon the difference between the stock's sale price and the fair market value at the time of exercise.

When the NSQO holder recognizes income, the employer is entitled to a corresponding deduction (see Tax Consequences under Restricted Stock).

Securities Law Considerations

The anti-fraud provisions of the federal and state securities laws will apply to the offer and sale of NQSOs and underlying common stock. For federal purposes, the grant of an NQSO typically is not considered to be a "sale" of or an "offer to sell" a security requiring registration; however, the exercise of an NQSO for underlying stock is deemed to be a "sale" of a security requiring registration or an exemption therefrom. In this regard, it is possible that an NQSO Plan may qualify for certain "private offering" exemptions. State blue sky laws may impose different or additional qualification requirements or exemption standards (for example, California deems the grant of an NQSO to be a "sale" requiring qualification or an exemption while the subsequent exercise of an NQSO is a non-event).

G. Incentive Stock Options – IRC § 422

General Considerations

Incentive Stock Options ("ISOs") permit holders to purchase shares of an issuer's stock during a specified period of time and for a fixed price, thus providing performance-based compensation. Unlike other option plans (e.g., non-qualified stock option ("NQSO") plans), if statuary requirements are met, holders can defer recognition of income until the sale of the underlying stock; however, the issuer will not benefit from a corresponding tax deduction. The statutory requirements applicable to an ISO include (i) shareholder approval, (ii) a 10-year limit on exercisability (five years for 10% holders), (iii) exercise prices must equal or exceed fair market value of the underlying stock at the time of grant (110% of fair market value for 10% holders), (iv) transferability restrictions, (v) ISO holders must be employees of the issuer or a parent or subsidiary at the time of grant and until at least three months prior to exercise of ISO; and (vi) the aggregate fair market value determined at the time of grant for stock exercisable for the first time by an ISO holder during any calendar year cannot exceed $100,000.

Stock acquired upon exercise of an ISO may not be used to exercise another ISO (e.g., a "cashless" exercise) prior to the end of the two-year period after the date of grant of the ISO and one year after its exercise without terminating the ISO tax benefits.

Tax Consequences

Holders of ISOs recognize no taxable income on exercise of an ISO if the statutory requirements are met; however, the excess of the fair market value of the stock over the option exercise price is a preference item which must be included in computing the holder's alternative minimum taxable income for the exercise year. A holder's sale of the underlying common stock is taxable as capital gain or loss based upon the difference between the stock's sale price and the option exercise price. If the statutory requirements are not met, holders recognize ordinary income as compensation for services (either at the time of exercise (similar to NQSO) or upon a disqualifying disposition of the underlying stock).

The issuer normally has no income tax consequence. However, if a holder recognizes ordinary income due to the failure to meet the statutory requirements, the issuer is entitled to a corresponding deduction and must withhold.

Securities Law Considerations

Similar to NQSO treatment. Please refer to the section entitled "Securities Law Considerations" included with the summary outline on NQSOs.

H. Stock Appreciation Rights

General Considerations

Stock appreciation rights (SARs) are contractual rights granted to executives to receive income based on share appreciation, i.e., the excess of the market value at exercise date over a pre-established price. SARs may be payable either in cash, stock or a combination of cash and stock. The form of payment may be at the option of the employer or, subject to certain limitations, the employee. The plan may limit the amount of share appreciation for which an executive is eligible. Such plans may be combined with ISOs or NQSOs, and the executive may be given the opportunity of electing one or the other. SARs are rare in small businesses.

Tax Consequences

Upon the exercise of an SAR, the employee will include in gross income an amount equal to the cash and/or fair market value of the shares of stock received unless the shares are restricted. The employer is entitled to a corresponding deduction and must withhold.

Securities Law Considerations

The anti-fraud provisions of the federal and state securities laws will apply to the offer and sale of SARs although SARs in their own right typically do not constitute securities for which federal registration is required. Applicable state blue sky laws may have requirements which are distinct from federal securities law with respect to SARs (in California, for example, although the grant of an SAR which is exercisable for cash only is exempt from state qualification requirements, the grant of an SAR which may be settled for stock requires qualification or an exemption).

I. <u>Employee Stock Purchase Plan ("ESPP")</u>

<u>General Considerations</u>

An ESPP typically is established by <u>larger</u> businesses to permit a larger number of an issuer's employees to acquire employer stock. ESPPs usually are implemented through voluntary payroll withholding. This outline does not focus on ESPPs, as they are atypical in a small business.