Equity compensation as a succession planning device

Boost closely held business transitions with management incentive payments

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Owners of closely held businesses typically have many concerns when they begin to think about transitioning ownership of the business. One of these concerns is how to ensure that new owners will be as deeply committed to the business as the current owners, who many times have built a business from the startup stage to its current successful position. This fourth article in a series on the use of compensatory devices in succession planning explores the use of equity-based compensation to address this concern.

Use of equity-based compensation

The second and third articles in this series discussed the use of employee stock ownership plans (ESOPs) and other retirement plans in succession planning. While company contributions to an ESOP transfer company value and also result in company ownership shifts, other retirement plans transfer value from the company without changing the ownership of the company. Equity-based compensation may or may not result in actual ownership shifts. As discussed below, some types of equity-based compensation transfer actual shares in the company, whereas other types align compensation to changes in equity value, but do not actually transfer shares. In almost all cases, equity-based compensation is provided only to key executives of a business and is provided directly to the executives, in contrast to retirement plans that hold accounts on behalf of employees.

Even when actual shares are transferred through equity compensation, a taxable sale event is not triggered for a selling shareholder, because shares are not purchased on employees' behalf; they are paid directly to them, from treasury or as newly issued shares, as compensation.

Equity-based compensation plans that do not transfer actual shares more closely resemble nonqualified retirement plans, which were discussed in the third article in this series. Because ownership is not transferred with these plans, they aid succession planning by reducing business value through additional payments to key executives. However, by aligning the 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. Even though the executives are not direct owners, they will be incentivized to act much like they own the business. Therefore, equity compensation is more valuable in succession planning when provided to executives who will be staying with the company.

Types of equity-based compensation plans

Phantom stock

Phantom stock is one tool used to align compensation to company performance without transferring actual ownership to the employees. Because it is not "real" stock, phantom stock does not have voting or dividend rights, but the amount 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's tax deduction is in the same year.

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 SARs of three to four times the number of shares that would be associated with phantom stock. A SAR is ordinary income to the employee and tax-deductible to the employer when the payment is received by the employee, just as with phantom stock.

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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 plan that will pay him the equivalent 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 to $120 per share, he will receive $60,000. Now assume that instead of a phantom stock plan, the president on July 1, 2014, received 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 $120, he will receive 2,000 shares times the $20 increase, or $40,000. While the SARs may seem less motivating to the president because they provide a lower payment, the risk of receiving nothing from the SARs may actually create greater incentive for the president to increase the company's value.

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 restriction may 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 receive the associated rights of the stock ownership. In addition to performance of services, the restriction may be related to some other condition. 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 employee is taxed at ordinary income rates on the value of the stock on that date, and the employer receives a corresponding deduction in its tax year in which the employee recognizes the income.

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A special tax rule exists that allows employees to elect to include the value of unvested stock in taxable income upon grant, rather than in the future when it vests. If such 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. The employee will have to weigh a number of factors, including current and future tax rates and the risk of forfeiture, when deciding whether to make the election.

Another variation of restricted stock is a restricted stock unit, which does not actually transfer stock to the employee until the associated conditions are satisfied. Therefore, a similar effect of incentivizing the employee is achieved, but with a promise to transfer property in the future instead of a current property transfer, the option for the employee to elect to include the income currently is not applicable. Instead, the income tax andthe 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 current (or future) price. If an employee exercises a stock option, the employee is the legal owner of the stock on that date and can immediately sell or hold the stock to sell in the future. 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 they can be exercised and the price at which they 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, and the entire amount is treated as capital gains income.

Nonqualified stock options

In contrast to an incentive stock option, a nonqualified stock option does not meet all of the requirements to qualify as an incentive stock option. In return, the option can provide much more flexibility in its terms. The tax consequence is that the employee is taxed at ordinary tax rates upon exercising the option on the difference between the strike price and the fair market value on that date. When the employee recognizes income upon exercise, the employer also receives a compensation deduction. This result assumes the stock is not publicly traded. If the stock is publicly traded, employees are taxed upon grant, rather than exercise.

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There are costs and benefits to both incentive stock options and nonqualified stock options. Incentive stock options are more restrictive but more tax-beneficial to employees. Nonqualified options provide much more flexibility to employers, but the employee pays tax sooner and a portion of the tax at a higher rate.

Stock bonus and 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 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 on the distribution date.

Rather than the company contributing shares to the plan, a stock purchase plan allows employees the option to purchase company stock. Therefore, a stock purchase plan more closely resembles a stock option plan, except that stock options are usually only given to key executives. A stock purchase plan must meet separate requirements and be available to a broad group of employees. The employee has to purchase the stock in a stock purchase plan, but generally does not pay income tax until the stock is sold, similar to the treatment of any other stock investment an individual might make.

Choosing an equity compensation plan

As with retirement plans, 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. Many times, an employer may have a number of different equity compensation plans at the same time. In addition to reducing company value, equity compensation may also be an important tool in planning for successor management. Because many closely held business owners are also in high-level management positions at their businesses, finding competent successor managers for the future 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.

Other considerations

While most stock bonus and stock purchase plans are designed as qualified retirementplans, other forms of equity compensation are not. As with nonqualified retirement plans, 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 stock appreciation rights. 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 stock appreciation rights 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, the reference to fair market value requires careful consideration. The 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 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.

Conclusion

If plans are used that require the employer to pay additional cash compensation to employees, such as with phantom stock or SARs, then cash is removed from the company, reducing the purchase price a potential buyer would have to pay. On the other hand, when actual stock is purchased by or given to employees, the current owners' equity is diluted with no current tax implications, which also reduces the price at which a given owner would sell his or her stock and thereby increases the number of potential buyers. In almost all cases, equity compensation plans will represent a relatively small proportion of the overall equity in the company. Therefore, they are generally used along with other tools when constructing an overall succession plan. However, equity compensation plans can nonetheless be extremely valuable to owners seeking to achieve certain goals. Other articles in this series on the use of compensatory devices in succession planning can be found here.

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