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Aligning Your Personal & Business Goals Towards A Successful Future

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To: Clients **From:** Stuart H. Sorkin, Esq.

Re: Incentive Employee Compensation **Date:** 9/30/2020

For most businesses, their greatest asset is their personnel, therefore, rewarding employees through some form of participation in increasing the value of the Company upon sale can provide a great incentive for your employees and provide you some opportunities to increase the value of the Company. Some of the reasons that you may want to consider an incentive compensation program are as follows:

1. A business will be more valuable to the extent the business can continue to successfully run if the owner is unable to work for some period of time.
2. Certain incentive compensation can be utilized to reduce the after-tax costs of life insurance for the owner.
3. Incentive compensation can be utilized to provide teeth to non-compete provisions upon an employee's termination.
4. To the extent that you can deliver an intact management team on a sale, it will probably increase the value of your business on a sale.
5. Incentive compensation allows the owner to test key employee on the employee's desire to be a part of an eventual management buy-out.
6. Since most management buy-outs require seller financing, incentive compensation allows the owner to make their Company a better credit risk for the Seller.

The remainder of this memorandum, summarizes the different types of incentive compensation.

A. <u>Actual Ownership</u>. The following is a summary of some of the advantages of having employees having actual equity ownership:

1. Actual employee ownership is a better form of motivation for employees because they "own a piece of the rock," which they feel is not as subjective as a promise of a future bonus.

2. If you just give the employees equity, then they will have ordinary income on a sale of the Company. If they purchase the equity as described below, then they will be provided a better tax situation when you transfer the Company because they will receive capital gains treatment with an effective tax rate of 15% on the appreciation in value rather than the ordinary income treatment with effective tax rates in excess of 40% on a receipt of a bonus.

3. By using a note for the purchase of the equity in the Company over the first several years after they acquire their equity your income should not significantly increase or decrease. The Company would bonus the employees the amount that you determine that you want them to pay towards the principal on the note but you would gross-up the amount of the note payment for the income taxes they have incurred by the receipt of the bonus. One consideration is that the employee will need to agree that under IRS rules that the note is required to be 30% or more

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guaranteed by the employee at the commencement of the note, however, first principal payments can eliminate the guarantee portion within the first one to two years. The bonus payments by the Company to the employees are completely tax deductible. The employees are in a lower marginal tax rate than you and the employees will be paying income taxes on income which would have been allocated and paid to you at your higher income tax bracket but the principal payments received from the employees back to the Company are not taxable to the Company because an entity does not recognize gain or loss on the sale of its own securities. However, employment taxes imposed on the bonus will be higher since the employees are probably not at the maximum social security level and you are. Therefore, the after-tax amount they can pay the Company on the note is higher than the amount of cash flow you will receive from the Company if you were just receiving your allocable share of the Company income.

4. To reduce any income tax consequences of bonusing or the size of the note, the Owner can create a liquidation preference for an owner class of stock to recognize part of the existing value of the Company and motivate the employee to grow the Company.

5. You can create a special class of equity in which the Employee will only realize the full value of their equity if they remain with the Company for several years. This is the concept of a vesting valuation in the equity. For example, the valuation can vest over four years with by stating that if the employee leaves within the 1st 2 years of receiving the stock the redemption price is the higher of: (i) what the employee paid for the stock or (ii) the appraised fair market value of the Company adjusted for the liquidation preference, if any, multiplied times 25% and increasing this percentage for each year of service.

6. If employees/members leave the Company, they will be receiving some form of pay-out from the Company for their equity. Using a note for the payment of the redemption price and allocating a portion of the redemption price to a covenant not to compete: (i) reduces the financial stress of a redemption and (ii) gives the Company significantly more leverage in enforcing covenants not to compete or preventing employees from taking other actions which are detrimental to the Company after they terminate employment. This reduces litigation risks to the Company because the Company can just stop making payments under the note or covenant, if an employee begins to compete and the employee would be force to litigation if they believed that they were not competing. To protect the employee the Company should pay any amounts potentially due to the employee into an escrow.

7. By creating an employee class of equity, the owner can create a pay-out structure on a change in control that incentivizes the employee to stay after closing, which reduces the anxiety of the employee if the Company is sold and adds value upon sale because the owner can deliver an intact management team to the buyer. For example, the pay-out would provide for a small percentage pay-out at closing with a large percentage paid out at the earlier of: (i) one year after acquisition or (ii) 30 days after constructive termination and then a percentage paid out over the term of a post-employment covenant not to compete. This creates a win/win, the employee knows that upon sale, they have a guaranteed job for 1 year or a significant severance package if the acquirer tries to change the employee's compensation, duties, or location and by having the

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employee locked in the owner has added value to the Company and increased the likelihood of closing because a key employee can no longer effect the negotiations of the definitive agreements.

8. One caveat for the owner is that the owner must get the employee to execute a Stockholders Agreement in order to be able to control the employee's disposition of the stock after the employee purchases the stock. I can provide a separate memorandum on the issues in drafting a Stockholders Agreement, if requested.

B. Non-Statutory Stock Options.

Non-Statutory Options ("Non-Statutory Options") do not meet the requirement for statutory options (i.e. ISO or Employee Purchase Plan) and as a result can be issued to employees or independent contractors and or their beneficiaries on a discriminatory basis for the performance of services to the Company. The employee will be taxed on the fair market value of the Non-Statutory Options less the amount, if any, paid for the Non-Statutory Options. The Company will receive a tax deduction in the amount of income included by the employee in the same year. The income will be included in the employee's compensation, the year in which the Non-Statutory Options have a "readily ascertainable fair market value" which will generally be in the year when the Non-Statutory Options are exercised. However, an employee may elect to be taxed at the grant date if a fair market value for the Non-Statutory Options can be ascertained.

Unless the Non-Statutory Options are actively traded on an established market, the Non-Statutory Options must meet all the following conditions to have a readily ascertainable fair market value at the grant date:

(i) The Non-Statutory Options are transferable by the optionee;

(ii) The Non-Statutory Options are exercisable immediately in full by the optionee;

(iii) The Non-Statutory Options and the shares subject to the Non-Statutory Options are not subject to any restrictions, other than a lien to secure payment, which will have a significant effect on the fair market value of the Non-Statutory Options;

(iv) The value of the shares subject to the Non-Statutory Options can be ascertained;

(v) The probability that the shares subject to the Non-Statutory Options will increase or decrease during the option period; and

(vi) The length of time during which the Non-Statutory Options can be exercised.

In interpreting these rules, the Tax Court has held a restriction that an employee remains as an employee for one (1) year was held to have a significant effect on value and accordingly, the Non-Statutory Options did not have a "readily ascertainable" fair market value. Additionally, the IRS looks to the earnings potential of the Company, corporate assets and the success of similar ventures in evaluating the fair market value and the potential for change therein.

The Company may want to restrict the transferability of the Non-Statutory Options or require the continued employment of the option holder as a condition for exercising the Non-Statutory Options, especially if the option period is for a substantial period of time. The length of

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the option period also will affect the ability to ascertain the value of the stock subject to the Non-Statutory Option.

In order for the Company to take a deduction for the Non-Statutory Options, the IRS requires the Company to withhold federal taxes on the amount which is to be included in the employee's income. Even if there are no restrictions on the issuance of the Non-Statutory Options as to the option, the exercise price or the length of the option period, the Company may still be unable to claim a current tax deduction because the Non-Statutory Option does not have a readily ascertainable fair market value.

In the year in which the employee receives the Non-Statutory Options he must attach a statement to his tax return stating the following:

(i) Employee name and address;
(ii) Description and the number of the shares subject to the Non-Statutory Options;
(iii) The option period;
(iv) Whether, at the grant date, the Non-Statutory Options have a readily ascertainable value; and
(v) Whether the Non-Statutory Options are non-statutory.

C. <u>General Explanation and Considerations of a Phantom Stock Plan</u>

A phantom stock plan provides key employees of a company with the economic benefits of business ownership, but without actual ownership. Instead, employees are rewarded with performance-based compensation aligned with the performance of the company's overall business. As the value of the business increases, so does the potential for extra compensation to the employees who participate in the phantom stock plan. Under such a plan, employees are rewarded for the future success of the business, while the employee can avoid the actual liabilities, risks and uncertainties that owners would be subjected to as owners. Phantom stock gets its name because, typically, the amount of compensation received by an employee who participates in a phantom stock plan is measured by an increase in the value of a theoretical block of stock. The idea is to give the employee a financial reward as if he or she had actually received a block of stock in the company.

The tax treatment of benefits under a phantom stock plan is straightforward. The employee pays ordinary income tax on the amount received under the plan when paid as if he or she were paid wages. The company, on the other hand, deducts from its income the amount paid to an employee who participates in the phantom stock plan as an ordinary and necessary business expense when it is actually paid to the employee. For financial statement purposes, under GAAP (generally accepted accounting principles), the value of phantom stock is treated as a compensation expense charged against earnings of the company in the year of the grant and prorated over the applicable vesting period. The expense is then adjusted annually as the value of the award grows or declines.

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Equally important, a phantom stock plan is an un-funded contractual promise of the company and the company usually does not set aside funds or establish a reserve for purposes of making the contemplated payments. This is required under the Internal Revenue Code to avoid having to have the employee recognize phantom income from the phantom stock plan before his/her actual receipt of the payments. Payments under a plan must be projected carefully to anticipate the cash needs of the company.

D. <u>Specific Considerations in Phantom Plans</u>

1. **Valuation** One of the key elements to the phantom stock plan is the formula for valuing the business at the inception of the plan and again at the payment dates, and thus, the determination of a participant's benefits under the plan. A formula may be as simple as measuring the change in net equity on a balance sheet from a current date to a future date, but it is usually more complicated. A well-designed formula should encourage behavior, which creates the ultimate results desired by the company generally increased profitability and overall equity value. For this reason, an often-used formula for measuring the change in the value of a business is based on the earnings of the company or a formula based on a multiple of the company's "EBITDA" earnings before accounting for interest and taxes paid by the company and before accounting for depreciation and amortization of the company's assets.

2. Additionally, the formula should be one that is calculated by an independent third party to provide the employee's confidence that the owner cannot manipulate the calculation. On the other hand, depending on the type of plan, you may be required to make the calculations at least annually; therefore, use of a valuation expert can get expensive. Therefore, the calculation should be completed by your outside CPA but his calculation must be binding on all parties to avoid the expense of challenges by the employees.

3. **Compensation of Employees** The compensation of employees under a phantom plan can be in the form of either or both current annual compensation and compensation on sale of the business. Current compensation would be in the form of a bonus based upon each employee's ownership of phantom stock, which would be equivalent to a dividend on the phantom stock. The compensation for a sale would be based upon the difference between the price per share when the phantom stock was issued to the employee and the sales price per share upon sale.

4. **Methodology for Vesting Value in Phantom Stock** The reason for vesting ownership in the phantom stock plan is that employee should not fully benefit from their phantom stock unless he has remained with the Company for a certain period of time, however, if the employee has remained with the Company for a significant period of time and/or his separation from the Company was not voluntary (death, disability or involuntary termination without cause), then he should receive some benefit from the phantom stock plan.

There are two common methods for vesting the value of the phantom stock. The first is the employee is awarded a certain number of shares in the plan, however, his/her ownership

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vests over several years such as a rate of 20% per year for five years. The second is that the valuation of the value of the phantom stock increases for purposes of a buy-out such as a rate of 20% per year for five years. A third method limits vesting until a point after the Company is sold to ensure that the employees stay with the company after the sale of the Company. There is no difference between the two vesting schedules if you are only compensating the employees upon a sale of the Company. However, if you elect to have current compensation to the employees under the Plan then there is the following difference. Under the first method, generally, the Company would only pay dividends on an employee's vested ownership in phantom shares, but under the second method the employee would receive dividends on all shares awarded, the penalty for leaving early would only happen for an early termination of the employee's interest in the phantom stock plan. Therefore, under the first method the employee gets a larger bonus based on the length of time they are employed by the company, while under the second plan the annual bonus compensation is at a constant rate throughout the participation in the phantom stock plan. However, regardless of the vesting schedule, an employee generally becomes fully vested in their phantom stock upon a sale of the company.

It is typical that different reasons for separating from the company will have different effects of the vesting schedule. Therefore, you will need to determine the effect on the vesting schedule in the following circumstance: (i) death, (ii) disability, (iii) termination without cause, (iv) termination with cause; and (v) voluntary resignation.

5. Method of Payment

If you decide to have annual payments, they would be equivalent to a dividend on the phantom stock, would generally be paid in cash in one payment. Alternatively, the bonus is in the form of additional phantom stock and in some cases, the employee can elect to have the bonus paid in cash, however, it is not unusual to reduce the value of the bonus, if the employee elects a cash payment. From an income tax planning prospective, it may be advisable to calculate the payment by annualizing November 30's profit so that the bonuses under the phantom stock plan would be deductible against the income from the year from which they relate rather than the next succeeding tax year. This type of calculation would assume that typically the income for December is about the same as all other months.

Except in the case of a payment to terminate an employee's interest in the phantom stock plan because of the employee's death, I would recommend utilizing a similar pay-out structure as described in Section A.7 above under actual equity. Since there is no reason for a covenant not to compete if the employee dies, a payment under the phantom plan in this case could be paid in a lump sum or deferred to be paid over time.

E. <u>Non-Qualified Deferred Compensation</u>

In some cases, key employees may be too close to retirement to want to participate in an incentive compensation plan that is based upon equity. In that event, the Company may want to establish a Non-Qualified Deferred Compensation Plan.

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A nonqualified deferred compensation plan ("NDCP") is a contractual agreement in which a participant agrees to be paid in a future year for services rendered this year. Deferred compensation payments generally commence upon termination of employment (e.g., retirement) or pre-retirement death or disability. Nonqualified deferred compensation plans are often geared toward anticipated retirement in order to provide cash payments to the retiree and to defer taxation to a year when the recipient is in a lower tax bracket. These types of plans are not subject to the non-discrimination rules imposed on quailed plans, therefore, benefits can be offered a select group of employees. Consequently, the cost of this benefit is lower since it accrues to fewer people.

There are two broad categories of nonqualified deferred compensation plans: elective and non-elective. In an elective NDCP an employee chooses to receive less current salary and bonus compensation than he or she would otherwise receive, postponing the receipt of that compensation until a future tax year ("Deferred Savings Plans"). Non-elective NDCPs are sometimes referred to as supplemental executive retirement plans ("SERPs") in which the employer funds the benefit and does not reduce current compensation in order to fund future payments. Such plans are, in essence, post-termination salary continuation plans. The argument behind such non-elective plans, funded by employers, is the retention of key employees.

SERPs generally are structured to mirror defined-benefit pension plans. They promise a stated benefit from the employer at retirement. SERP benefits, which can be allocated in conjunction with other benefit plans like qualified-plan savings and Social Security benefits, may be calculated in any number of ways. Employers may choose to pay their executives a flat dollar amount for an agreed-upon number of years; a percentage of their salary at retirement multiplied by their years with the company; or a fixed percentage of their salary at retirement for a given number of years.

Companies also have the option of funding SERPs either through general assets (at the time of the employee's retirement) or via sinking funds or corporate-owned life insurance ("COLI"). Businesses that utilize the sinking fund method allocate money on an annual basis to a fund that will cover benefit payments as they come due. This money can be invested by the company as it sees fit, but it is nonetheless earmarked for retirement payments.

Under the COLI funding method, businesses buy life insurance plans on those directors and executives that they wish to compensate. Each company pays the premiums on the purchased policies, and as each executive retires, the firm pays out his or her benefits from operating assets for a previously established period of time. The key benefit under the COLI arrangement is that his or her business is designated the sole beneficiary of the tax-free proceeds from the insurance policy. Upon the death of an executive for whom such a policy has been acquired, the company is reimbursed for some or all the costs of the insurance plan—the actual benefits paid, the insurance premiums. Entrepreneurs should note, however, that their firm will not receive a tax deduction for its contributions to a SERP until the director or executive actually receives the benefit payments (businesses using qualified compensation plans, on the other hand,

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receive deductions in the current year). With the reduced corporate tax rate of 21% on C corporations, the use of a COLI is more tax effective than with an S corporation or LLC.

Deferred savings plans are similar to 401(k) plans in that affected employees are allowed to set aside a portion of their salary (usually up to 25 percent) and bonuses (as much as 100 percent) to put into the plan. This money is directly deducted from employee paychecks, and taxes are not levied on the money until the employee receives it. Plans are set up to cover obligations in one of two ways. First, the company simply guarantees a fixed rate of return on the deferred contributions, which come from its general operating assets at the time of payout. Second, the company ties each executive's savings to the performance of a particular mutual fund which the executive selects from among several offered by your plan. Companies that set up a fixed rate of return on the deferrals may invest the monies in question however they wish, provided they ultimately meet their payout obligations. Additionally, some businesses have established a policy wherein they will offer matching funds on employee deferrals or add profit-sharing or incentive-based contributions. If an executive enrolled in this type of plan dies or is fired from the company prior to retirement, he or she (or their family) receives a lump-sum payout of their benefits.

In order for the employee to avoid the assessment of a current income tax liability for payments to a non-qualified deferred compensation plan is that the funds cannot be permanently set aside for the employee. Accordingly, funding for nonqualified deferred compensation plans will not be protected from creditors if the company that created them files for bankruptcy.

F. <u>Stay Bonus</u>

A stay bonus can provide a significant incentive to key employees to remain with a Company after a change in ownership whether such change is planned such as a sale or unplanned such as the death or disability of an owner. The benefit of a stay bonus is that there is no real current cost to the Company because the bonus is only paid a period of time after a change in ownership occurs. The most common form of stay bonus would be calculated based upon a percentage of the employee's current compensation at the time of the change in ownership. The pay-out would be at the earlier of: (i) one year after a change in ownership or (ii) within 30 days of an employee being subjected to a change in compensation, title, location, or responsibilities by the new owner.

This type of bonus plan will add value on a planned transfer because the new owner knows that he will either retain a key employee for a year after acquisition or if the new owner decides to terminate the employee before one year, the employee already has a funded severance package. This type of bonus plan will ensure that key employees will stay with the Company in the event of an unplanned exit by the owner, which should assist in preserving the value of the business. Finally, if an employee know that they are protected in the event change in ownership, they will not be as concerned about a change, when it happens, which should assist in the transition.

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G. **Bonus Pool**

The bonus pool is a great way to reward employees who are not of the level that you would want to give actual ownership. As we discussed, the bonus pool allows you to set a percentage of the proceeds that would be paid to the employees on a triggering event. However, you are provided the flexibility to make annual changes in the amount each employee will receive from the pool based upon both objective (length of service and performance goals) and subjective (attitude and administrative cost efficiencies). The cost of set-up of the bonus pool is minimal and there is neither an annual maintenance cost associated with the pool nor will your income be reduced until there is a triggering event. Finally, a bonus pool only rewards those employees who are employed by the Company when the triggering event happens. However, that is also why the bonus pool is not necessarily a great form of employee motivation because they have no idea when they will receive anything from the bonus pool. Initially, a bonus pool will provide some motivation but as you go through the years without a trigger event the potential for a bonus becomes more illusory and less effective as a motivational tool.

I hope you will find this memorandum useful and if you have any questions, please call me.

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