

## Fostering Ownership Attitudes:

### Creative Equity Compensation Plans for Employees

#### Summary of Common Equity Compensation Instruments

	Type of Plan	Benefits	Tax & Accounting Treatment	Drawbacks
<b>Individual Plans</b>	Stock grants <ul style="list-style-type: none"> <li>• vested grants</li> <li>• time restricted stock grants</li> <li>• performance restricted stock grants</li> </ul>	Help cash flow Provide continuing motivation Simple to establish; easy to understand Flexible	Treated as cash bonus Tax liability for employee Payroll tax requirement for employer	Employee cash flow problems Ownership value may not be clear Employers must recognize comp expense for financial accounting purposes
	Non qualified stock purchase programs	Avoid dilution Can improve cash flow Simple, flexible Employee commitment (own money invested) Generate cash for company Employees as investors – aligned with goals	Straightforward – but note 83b election – may need to hold for 5 yrs Not treated as compensation	Employees must provide cash Tax consequences – 83b Expensive to set up Raise securities compliance and disclosure requirements
	Stock option plans Incentive stock options (ISO) Non-qualified stock options (NSO)	Company selects who receives option awards, how many, conditions Tie employee rewards to future success of company Retention tool Option to use own money at some date, or not	No tax consequence to employer or employee at time granted if granted at fair market value Tax at exercise differs by ISO/ NSO Must be expensed on income statement – complex valuation required	May be expensive to set up and maintain Complexity of plans and tax rules – need to educate If stock price drops, options rendered worthless in employee eyes ISO benefits conflict with Alternative Minimum Tax provisions
<b>Company-wide Plans</b>	Qualified employee stock purchase plans (Section 423 plans or ESPPs)	Meaningful to employees (own money invested) May provide discount from fair market value offered to employees Typically pay through payroll deductions – no pressure to sell for cash Generate some capital for company	Many Internal Revenue Code (IRC) and securities requirements Discount over limit is taxable. Considered compensatory. Impacts earnings. Employee must recognize income as of date stock is sold. Generally limited to public companies.	Employees of lower comp levels may not participate Somewhat complex tax implications – communications to employees needed Fairly modest legal fees to set up; charge for maintaining Raise admin/ legal requirements for compliance with securities laws
	Employee stock ownership plans (ESOP) Leveraged Non-leveraged	Significant tax advantages Unique ability to borrow money Enable transfer of ownership to employees/ management vs. outside sale	Tax benefits: contributions deductible, certain cash dividends deductible, cap gains tax deferred if 30% owned by ESOP, ESOPs in S corps can provide exemption from tax Can have negative accounting impact if following GAAP	Expensive to set up and administer. Usually requires equal % for all (not based on merit). Independent appraisal of stock value required annually. Only work for profitable company with equity to share.

	Type of Plan	Benefits	Tax & Accounting Treatment	Drawbacks
Savings Plans	410k and retirement plans using stock (KSOP: 401k combined with ESOP)	Current tax deduction and deferral on future asset accumulation Save for retirement with pre-tax dollars Company can fund with employer stock, less cash required Can generate capital for company	Tax incentives to employers and employees – company contributions of cash or stock are fully deductible Reported as qualified plan contributions, but changes in value of assets not recorded If combined with ESOP, follow accounting for ESOPs	Expensive to establish, administer and maintain (with addition of stock) Raises securities compliance and disclosure requirements Must meet IRS requirements for anti-discrimination All employees who meet Internal Revenue Code standards must be allowed to participate
	Non qualified deferred comp plans	Allow employee to defer tax on future comp Low cost to implement Flexible, less regulated Comp in excess of maximum for qualified can be deferred in non-qualified plans	Deferred comp must be expensed as it vests – can result in significant extra current comp expense Deferred taxation	Must be limited to select group; not broad-based equity sharing Plan assets are subject to claims of creditors Severe tax penalties for violations New IRC Section 409A limits scope of deferral
Synthetic Equity	Stock appreciation rights (SAR) & Phantom stock (deferred cash comp based on appreciation of stock, no stock transferred)	Long term motivation without dilution Adaptable to various objectives No cash outlay required from employees Can be useful in providing stock like incentives for foreign employees	No tax consequences on grant if granted at fair market value Payout is future cash liability to company – appreciation of SARs and value of underlying shares for Phantom Stock	Can be significant cash drain on company when cash entitlement matures Once paid out, employees have no further ownership interest New IRC Section 409A applies to SARs that are granted below fair market value
International Equity	Stock programs for US companies operating abroad Stock options Int'l ESOPs SSP, Restricted Stock Grants, Synthetic Equity	Replicate success of US plans in motivating employees to think like owners Common incentive to all employees Int'l identity for corporation among dispersed workforce Keep stock in friendly hands Continuity in benefits for expat employees	Tax treatment, accounting requirements and other regulations vary by country	Complex registration requirements, vary by country S-Corporations may not have non-US resident shareholders Currency volatility Some countries prohibit local residents from holding foreign currency/ securities Language and cultural barriers to overcome in communications Varying costs - legal review, tax complexities, administration etc.

Source:

Binns, D; Staubus, M and Ron Bernstein. The Entrepreneur's Guide to Equity Compensation, Fourth Edition. The Beyster Institute at the Rady School of Management, University of California, San Diego. 2006.

## ***Implementing Equity Compensation***

What are your objectives, and how can you choose a plan to meet them? Here are some key questions to consider as you decide on an equity compensation plan that is right for you, your business and your employees...

- Equity as reward or incentive?
- Population to be covered?
- Tax impact? Qualified (Q) vs Non-Qualified (N)
- Cash incentives or participation? (All of the instruments discussed here offer participation of some kind, even if reward is paid in cash in the end.)
- Immediate (Now) or deferred (Later)?
- Formula/ broad-based (F) or discretionary rewards (D)?
- What do I expect from employee ownership?

	<b>Equity Compensation Instruments</b>								
	<b>Stock grants</b>	<b>Non qualified stock purchase</b>	<b>Stock option plans</b>	<b>Qualified employee stock purchase</b>	<b>Employee stock ownership<sup>1</sup></b>	<b>401k and retirement plans</b>	<b>Non qualified deferred comp</b>	<b>Synthetic equity</b>	<b>Int'l equity</b>
<b>Profit Sharing</b>	X				X		X	X	
<b>Direct Ownership</b>	X	X		X	X				
<b>Potential Ownership</b>			X				X		
<b>Equity Bonus</b>								X	
<b>Tax Impact</b>	None <sup>2</sup>	None <sup>2</sup>	None <sup>2</sup>	Qualified	Qualified	Qualified	None <sup>2</sup>	None <sup>2</sup>	None
<b>Immediate or Deferred</b>	Either	Either	Deferred	Either	Deferred	Deferred	Deferred	Deferred	
<b>Formula or discretionary</b>	Discr.	Discr.	Discr.	Formula	Formula	Formula	Discr.	Discr.	Discr.

<sup>1</sup> ESOPs are required to operate based on independently determined fair market value. Other vehicles may rely on fair market value as determined (as described in IRC Section 409A) by the Board of Directors based on a reasonable formula applying reasonable assumptions.

<sup>2</sup> No tax impact provided grants are made at Fair Market Value and, where applicable, the provisions of IRC Section 409A, limiting the scope of deferral, are followed.