USPS Address:
P.O. Box 190
Middletown, NJ 07748

Overnight and Hand Delivery:
125 Half Mile Road
Red Bank, NJ 07701

Attracting, Retaining And Motivating Employees Through Equity Based Compensation Programs

By Philip D. Forlenza, Esq.

Stock based compensation has become an important element in attracting, retaining and motivating employees. As competition for talent increases, employers can use equity based arrangements to distinguish themselves from competitors. In addition, these types of programs can help increase employees' dedication to the firm, improve work effort, reduce turnover and improve company morale. There are a variety of stock based incentive programs that a company can implement to assist it in achieving these goals, including those discussed below.

Incentive Stock Options

Incentive stock options (ISOs) granted under plans which meet the requirements of Section 422 of the Internal Revenue Code are a popular way to reward and attract employees. What makes ISOs particularly attractive is that neither the grant nor the exercise of the option is taxable to the employee who receives the option if the stock acquired upon exercise is held for two years from the date of grant and one year from the date of exercise. If these requirements are met, subsequent sales of the stock result in capital gain treatment for the employee. If the holding periods are not met, the sale of the stock will be treated as a disqualifying disposition and the employee will be taxed at ordinary income tax rates on the difference between the option exercise price and the fair market value of the stock at the time of exercise. To qualify for ISO treatment, certain requirements must be met including the following:

- The option must be granted under a written plan document which specifies the total number of shares which may be issued under the plan.
- The option plan must be approved by shareholders within 12 months of its adoption.
- Each option must be granted under a written agreement which sets forth the option price and the term of the option.
- The option cannot be transferred by the holder other than by will or the laws of descent.
- The option must have an exercise price equal to or greater than the fair market value of the stock on the date of grant; however, if the option is granted to a holder of more than 10% of the issuer's outstanding voting stock, the option exercise price must be at least 110% of fair market value on the date of grant.
- The term of the option cannot be greater than 10 years from the date of grant (or five years in the case of an option granted to a holder of 10% or more of the issuer's voting stock).

- The aggregate fair market value of shares with respect to which options become exercisable by an individual for the first time during any calendar year cannot exceed $100,000.

Non-Qualified Stock Options
Non-incentive or "non-qualified stock options" are frequently used by companies that wish to retain the flexibility to issue options having exercise prices below fair market value or that wish to grant options to parties that are not employees of the company, such as non-employee directors and consultants. Generally, the grant of the option is not taxable to the employee. The primary difference between a non-qualified stock option and an ISO lies in the tax treatment. The holder of a non-qualified stock option generally realizes ordinary income upon exercise in an amount equal to the difference between the fair market value of the stock on the date of exercise and the exercise price of the option. The employer can deduct an equal amount as compensation expense.

Restricted Stock Programs
Generally, restricted stock programs involve an award to or a purchase of stock by an employee. Shares issued under these programs typically "vest" over a period of years. If the employment of the recipient terminates, any shares not vested are forfeited or repurchased by the company at a fixed price. If an election is not made by the recipient under Section 83(b) of the Internal Revenue Code, (a) the award is not taxable until the shares are no longer subject to the risk of forfeiture and (b) the recipient realizes ordinary income when the risk of forfeiture lapses in an amount equal to the fair market value of the stock on that date minus the purchase price, if any, of the stock. If the Section 83(b) election is made, the employee will realize ordinary income on the date the stock is acquired in an amount equal to the difference between the fair market value on that date and the purchase price, if any, of the stock.

Stock Appreciation Rights
Stock appreciation rights (SARs) are awards which provide employees with a contractual right to receive an amount equal to the appreciation in the value of a share of employer stock over a certain period of time based upon increases in stock over a certain starting benchmark. Often, these awards are settled in cash, stock or a combination of cash and stock. If an employee elects to receive the appreciated value in cash, the cash is taxable to the employee as ordinary income. If the employee receives the appreciated value in stock, the stock received is taxable to the employee as ordinary to the extent of the difference between its fair market value and the amount the employee paid, if any, for the stock. Usually, employees are not asked to pay any amount for the employer stock upon the exercise of an SAR. SAR plans are more frequently adopted by publicly traded companies.

Employee Stock Ownership Plans
An Employee Stock Ownership Plan (ESOP) is a qualified, defined contribution employee benefit plan that invests primarily in the stock of the employer company. ESOPs are governed by the Employer Retirement Income Security Act of 1974 (ERISA) and therefore must not discriminate in favor of highly compensated employees. To establish an ESOP, the company creates a trust to which it makes annual contributions, and then the contributions are allocated to individual employee

accounts. ESOP accounts are frequently set up to vest over time, and employees only have access to the balance of their accounts at specified times.

In addition to providing an incentive program for employees, ESOPs are frequently used to acquire the shares of a departing or retiring owner. The owner can defer tax on the gain made from the sale of the stock to the ESOP if the ESOP holds 30% or more of the company's stock after the transaction and certain other requirements are met.

ESOPs can be established on a leveraged and non-leveraged basis. In a non-leveraged ESOP, the company contributes stock or cash to the ESOP which is then used by the ESOP to buy the company's stock. In a leveraged ESOP, the ESOP typically borrows funds from a third party lender, with the company guaranteeing the debt. The funds are used to buy stock from the company or from existing shareholders and the company makes annual contributions to repay the loan. ESOPs offer certain tax advantages to sponsoring employers which can improve the employer's cash flow, including:

- Employer contributions to an ESOP (i.e., employer securities or cash used to buy employer securities) are tax deductible.
- The deductibility of employer contributions allows a sponsoring employer of a leveraged ESOP which makes contributions to repay an ESOP loan to deduct both principal and interest.
- Dividends paid on ESOP stock (which can be used to repay an ESOP loan or passed through to participants) are tax deductible.

The rules governing distributions by an ESOP are complex, but generally an ESOP must allow a participant to elect to receive his vested account balance within one year after the end of the plan year during which he terminates employment because of retirement, or not later than one year after the end of the fifth plan year following the plan year during which employment is terminated by reason of resignation or dismissal. An ESOP must provide that a participant entitled to a distribution may demand that the distribution be made in the form of employer securities, except in the case of an S corporation or if the employer's charter or by-laws restrict

ownership to employees or a qualified trust. If the employer stock is not publicly traded, ESOP participants must be given the right to require the employer to repurchase distributed securities at fair value.

Phantom Stock

Phantom stock plans allow key employees to benefit from increases in the value of their employer without becoming actual owners of the equity. Typically, these plans provide employees with a payout, usually in cash. Generally a company that adopts a phantom stock program will establish phantom stock accounts for a select group of key employees and credit the accounts with fictional shares. These shares represent theoretical equity that mirror actual equity in the company and cannot

Giordano
Halleran &
Ciesla
Attorneys at Law

USPS Address:
P.O. Box 190
Middletown, NJ 07748

Overnight and Hand Delivery:
125 Half Mile Road
Red Bank, NJ 07701

be cashed out until sometime in the future. In other words, the phantom stock represents a contractual right to receive cash based upon a formula established by the company's management. Common approaches include paying a bonus based upon the value of the company's shares or an increase in that value over a period of time or at the time the employee leaves the company. Other approaches involve crediting employee accounts based upon revenue or profit levels or providing for a payout only upon the sale of the company. Phantom plans should be limited to a few select employees to avoid treatment under ERISA.

Advantages of phantom stock plans include:

- Employers have great flexibility in designing phantom plans. Because they are effectively contract rights, employers have great latitude in determining vesting schedules and the criteria for measuring increases in value and the timing of payouts.
- Employees do not obtain the rights of a shareholder, such as the right to call shareholder meetings, vote, receive notices of meetings, inspect books and records or bring claims for breach of fiduciary duty.
- Employees generally do not have to make a cash contribution.
- Plans can be designed to reward the performance of a specific division of a company.

Disadvantages of phantom plans include:

- Key employees might be discouraged by the fact that they are not actual owners of the company.
- Cash received is treated as ordinary income.

Employee Stock Purchase Plans
Section 423 of the Internal Revenue Code provides a mechanism for employees to acquire stock of their employer through payroll deductions. Payroll deductions accumulate over an "offering period" designated by the company, and shares are generally offered at a discount to fair market value. A participating employee can use the accumulated deductions to purchase shares or request a return of his contributions at the end of the offering period.

Section 423 provides favorable tax treatment to participating employees similar to that of ISOs in that neither the grant of the purchase right nor the exercise of the purchase right has any tax consequence to the employee provided that the employee holds the stock for two years after the date of the grant of the purchase right and one year from the date that the stock is acquired. If the employee holds the stock for the requisite holding period, upon the sale of the shares, the employee will receive ordinary income tax treatment equal to the lesser of (i) the fair market value of the stock on the date of the grant of the purchase right over the exercise price of the purchase right and (ii) the excess of the amount realized on the disposition of the stock over the exercise price of the purchase

USPS Address:
P.O. Box 190
Middletown, NJ 07748

Overnight and Hand Delivery:
125 Half Mile Road
Red Bank, NJ 07701

right. Any additional gain or loss recognized on the disposition of the stock will be long-term capital gain or loss. If the employees sells the stock before the expiration of the requisite holding period, the employee is required to recognize ordinary income equal to the excess of the fair market value of the stock on the date of exercise over the exercise price. Any additional gain or loss will be short-term or long-term capital gain, depending upon how long the stock is held after the purchase right is exercised.

Requirements for a Section 423 employee stock purchase plan include:

- The plan must be approved by the shareholders within 12 months of its adoption.
- Purchase rights may be granted only to employees of the employer or its parent or subsidiaries.
- All employees must be offered the opportunity to participate in the plan other than certain highly compensated employees, five percent shareholders (who are not permitted to participate), employees who have been employed for less than two years and employees whose customary employment is 20 hours or less per week or who are customarily employed for less than five months in any calendar year.
- The exercise price of the option must be no less than the lesser of 85% of the fair market value of the stock at the time that the purchase right is granted or 85% of the stock's fair market value at the time the purchase right is exercised.
- The maximum offering period cannot exceed five years if the purchase price is at least 85% of the fair market value on the date of the exercise of the purchase right, or 27 months if the purchase price is determined in another manner (such as a flat dollar amount or the lesser of grant date and exercise date).
- No employee can accrue the right to purchase stock at a rate that exceeds $25,000 of the fair market value of the stock in a calendar year.

The foregoing description of equity based compensation arrangements is intended to be extremely general in nature. Equity compensation plans can be designed in a myriad of ways, each of which may have significant tax and accounting ramifications. In addition, the tax consequences to any particular individual or company may vary depending upon the individual or company's particular circumstances.