Legacy by Design, LLC

Retaining Key Employees

Succession Planning

Farmers, Ranchers, & Family Business Owners

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Kevin Spafford, CERTIFIED FINANCIAL PLANNER™, helps farmers, ranchers, and family business owners plan for succession. Kevin's planning process is designed to enhance the family's financial security, create a smooth ownership transition, and mitigate the tax consequences.

As the architect of the *Farm Journal Legacy Project*, Kevin effected consumer behavior and improved the way family business owners engage in the succession planning process. Through the *Project*, Kevin has:

- Published more than 300 columns in Agriculture's leading magazines.
- Facilitated workshops for thousands of farm and ranch families across the U.S.
- Written multiple workbooks and created several client planning tools.
- Produced weekly eNewsletters for subscribers across the country.
- And, hosted 5 seasons of '*Leave a Legacy*' TV.

Prior to the publication of his book *Legacy by Design: Succession Planning for Agribusiness Owners* (Marketplace Books®) in 2006, Kevin founded Legacy by Design, a succession and financial planning firm dedicated exclusively to serving the succession planning needs of farmers, ranchers, and agribusiness owners.

Among a series of professional designations and licenses, Kevin is a CERTIFIED FINANCIAL PLANNER™ and he's earned a Bachelor of Science in Agricultural Management with a concentration in Business, from California Polytechnic State University, San Luis Obispo, CA.

On a personal note, Kevin enjoys flying, fishing, hunting, and camping. He and his wife, Anne-Marie, have been married 37 years. They are proud parents of their son Drew and his wife Dana, and their daughter Sara and her husband Michael. In July of 2018 they welcomed their first grandchild. They live in Durham CA.

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RYAN WEALTH MANAGEMENT

Legacy by Design, LLC
Succession Planning for Agribusiness Owners

RETAINING KEY EMPLOYEES

Unless they have capable successors and employees, many closely held businesses do not survive the departure of the owner. The chance of survival is further diminished if key employees leave instead of adapting to the new owners and management. Therefore, a business succession plan should contain strategies to identify and retain key employees. Even if the owner has a successor who is ready and able to successfully take control of the business when the owner retires, key employees will usually be necessary to ensure the business continues to grow and prosper. Key employees are not always limited to those in high-level control or management positions. They often include employees in important finance, marketing, or operational positions.

An ownership transition can cause key employees to question their continued importance to the business. They may have concerns about the business's future and their job security. A key employee also may be reluctant to train and mentor a successor (often a family member) who is not experienced enough to take immediate control since the family member could eventually take the key employee's position. Therefore, it is often necessary to offer the key employees additional incentives to ensure they remain with the business and support the successor(s).

There are numerous options for rewarding key employees' commitment, loyalty, and hard work. The most effective incentives are usually monetary. Generally, they are offered in the form of nonqualified plans so the incentives can be tailored to a particular person's situation. Nonqualified plans also provide the opportunity to tie the employee to the business by incorporating conditions that cause the forfeiture of benefits if the employee leaves or the business does not reach certain performance targets. This chapter covers the various incentives available to help retain key employees. However, since each employee is different, there is no standard for determining the amount of incentive required to retain someone. Thus, it will likely be necessary to combine various incentives described in this chapter to meet the individual needs and desires of key employees.

DEVELOPING A RETENTION STRATEGY

Retaining key employees during times of transition is vital to a business's success. Therefore, it is important to develop a strategy to retain those employees when formulating a business succession plan. This section discusses the seven key components of a successful retention strategy that will help entice key employees to stay with the company. Once an appropriate plan is in place, it should be evaluated periodically (at least annually) to see if it is working as intended or requires adjustments.

Identify Key Employees and Their Goals

When formulating a business succession plan, it is important to identify all employees who are critical to the continued success of the business. There is no standard definition of a key employee, although the term generally connotes upper-level management (e.g., president, vice president, etc.). However, lower-level managers or even rank-and-file employees may have valuable expertise and experience.

Once key employees are identified, a strategy for their retention can be formulated. The key to any retention strategy is designing incentives that will motivate that particular employee. For example, some key employees may desire equity ownership in the company. Others may be motivated by more current income or more income upon retirement. Although the business may not be willing to provide everything the employee wants, acceptable compromises often can be reached (e.g., an employee who wants equity may be satisfied receiving additional compensation based on the company's stock growth instead of receiving actual shares). The key is to identify incentives that motivate the employee and package the ones the business is willing to offer.

Although money is usually the biggest motivating factor, nonmonetary factors should not be overlooked as an incentive for key employees to remain with the business and contribute to its success. Flex time or part time employment may motivate employees who want to spend more time with family or pursue personal goals. Other incentives include job advancement and job enrichment. If there is a higher position for which the key employee is qualified, the company can provide an incentive for the employee to stay by offering the promotion, which should also offer higher pay. Job enrichment includes expanding the employee's responsibilities, assigning leadership on a new project, or enhancing the employee's decision-making role in the company. Top management's commitment to enrich an employee's job as a part of the ownership transition program can provide the key employee with an incentive to stay and make a positive contribution to that transition. Ultimately, the appropriate retention strategy usually contains a combination of monetary and nonmonetary factors.

Alleviate Fears through Communication

Employees may become apprehensive about their future when a business goes through an ownership change. Often, they are concerned that the business will not be as successful as before or fear the new owners will change the way the company operates. They may also feel a loss of goodwill and appreciation they had built up with the previous owner and resent having to re-establish their importance to the business. An employee retention strategy should anticipate and address these concerns.

Open communication is a good way to alleviate the key employee's fears about the company's future. To the extent possible, make the key employee aware of the owner's plans for succession. Knowing when the succession will take place, the owner's involvement during the transition period, and why the owner chose a particular successor can help alleviate the employee's concerns. Often, a meeting between the successor and key employee to discuss the successor's plans for the business will make the employee feel more comfortable. The meeting may help the key employee realize the owner has left the business in capable hands and may give the employee the opportunity to establish a rapport with the new owner.

Likewise, key employees can be uncertain of their role in relation to any family members being brought into the business. For example, nonfamily members know they will probably never be president of the company, so it is important for them to know where they stand in relation to family members who are on the same or similar rungs of the organizational chart. Clarifying this relationship may make nonfamily key employees more willing to train and mentor inexperienced family members.

Point out the Positives

Pointing out the benefits of continuing to work for the family business may help to retain key employees. Generally family businesses do not have excess employees to easily replace a key employee. Thus, key employees often benefit by job (and income) stability in a family business. Also, the owner may be more loyal to key employees. Often the owner and key employees have worked together to build the business. This shared history and mutual pride in past achievements often results in a much closer relationship between owner and employee than in a larger company. Finally, closely held businesses can avoid the sometime short-sighted management decisions and employee stress that result from a publicly traded company's pressure to meet Wall Street's quarterly earnings expectations. The lack of pressure to meet certain earnings and share price expectations allow a closely held company to adopt a more long term approach to business decisions.

Share the Responsibility for Success

The degree to which employees are allowed to participate in management decisions can impact a business's retention rate during an ownership transition. Many owners make all the business decisions. Delegating responsibility for some of these decisions allows key employees to contribute to the success of the business and enhances their perception of their value to the business. Involving key employees in the development and implementation of future business plans gives them a vision of the future that they are helping to create; therefore, they are more likely to be excited about staying and convinced that the visions can become reality.

Use Monetary Incentives Effectively

Money is a motivating factor for most employees. Ensuring that employees are paid at or above industry standards is important to maintaining high employee retention rates. An executive placement agency or consulting firm is a good source for competitive salary information. One of the biggest mistakes a business can make is increasing key employees' responsibilities during a transition in ownership without adequately adjusting their pay. In addition to providing competitive base compensation, there are other monetary incentives that can be offered as part of a total compensation package (e.g., bonuses for meeting short-term performance goals, and stock options, deferred compensation, etc. for reaching longer-term objectives and providing for the employee's retirement). An agency that specializes in the placement of high-level managers in a certain industry should be aware of the types of compensation packages currently being offered.

Choose Appropriate Nontaxable Fringe Benefits

In addition to providing key employees with the necessary monetary incentives, companies may be able to use nontaxable fringe benefits as additional retention and motivation tools. Broad-based fringe benefit programs (such as medical reimbursement plans or group-term life insurance policies) can be provided tax-free to employees. However, a company that is not already providing these benefits may be hesitant to add them because of the expense of making them available to a wide range of employees.

One way around this problem is for the employer to adopt tax-favored fringe benefits that are not subject to nondiscrimination rules.

Consider the Need for Employment Contracts

Although written employment contracts are rare in family-owned businesses, they can be useful in certain situations to help hire or retain a key employee. From the employee's perspective, such a contract can provide a measure of security (in the form of a salary guarantee, etc.) when the ownership and control of a company is transferred. If the company is being sold (especially to a nonfamily member) the existence of employment contracts with key employees should increase its value, since the purchaser has some assurance that key employees will remain with the company. In addition, an employment contract will normally provide the details of the employee's basic compensation and the terms of any bonus arrangement, deferred compensation, stock-based compensation, or severance benefits to which the employee is entitled. (Due to their length and complexity, deferred or stock-based compensation arrangements are sometimes spelled out in agreements separate from the actual employment contract.)

Besides being a means to document the employee's compensation arrangement, for an employer the benefits of an employment contract include the ability to provide for such provisions as the following:

- **A Noncompete Clause** Courts generally will not enforce such a provision unless it is reasonable as to geography, time, and types of activities restricted. Noncompete clauses sometimes contain a so-called antiraiding provision that prohibits a departing employee from hiring any co-workers for a period of time after the employee quits.

- **A Nondisclosure and/or Trade Secret Clause(s)** Courts are normally more willing to enforce this type of provision than they are a noncompete agreement because enforcing a nondisclosure or trade secret clause generally has a less serious impact on the employee's basic right to earn a living.

- **An Arbitration (or Alternative Dispute Resolution) Clause** Used to settle disputes between the employee and employer concerning the employment contract.

- **Patent, Invention, or Copyright Clause** Documents the rights of the employee and employer regarding any invention created or any patent or copyright secured through the employee's efforts while working for the employer. (Employment agreements requiring an employee to surrender invention rights to the employer normally are not enforceable if the employee developed the invention on personal time using personal tools and equipment.)

- **Anti-moonlighting Clause** The contract may contain a provision prohibiting the employee from undertaking any other business endeavor while employed by the company.

Even though employment contracts can be an advantage to both the employee and employer, they have some drawbacks. Because it is a complex legal agreement covering an important relationship with a valued employee, an employment contract should only be used when the company is willing to pay the cost necessary to have it drafted by a qualified employment law attorney who is familiar both with applicable state law and the business's unique circumstances and intentions. Failing to go to this expense can create unintended results that frequently come to light only after there is a disagreement.

An employment contract will also likely be viewed as undesirable if it binds an employee to a company or the company to an employee, even after the two discover they simply are not compatible. However, this potential problem can usually be overcome by providing in the contract that the employer and employee both reserve their rights to end the employment relationship simply by providing a certain number of days of notice. The amount of any termination payments, the length of any noncompete clauses, and other provisions applicable to the departing employee may be affected by which party initiated the contract termination.

USING EQUITY-BASED COMPENSATION PLANS TO RETAIN KEY EMPLOYEES

Providing key employees with an interest in the business through an equity-based compensation plan can be an effective way to retain their services during an ownership transition. Thus, a business succession plan should evaluate the merits of providing equity-based compensation for key employees.

There are three common stock-based compensation plans: (a) restricted stock, (b) incentive stock options, and (c) nonqualified stock options.

Restricted Stock Plan

A restricted stock plan transfers stock to an employee subject to certain restrictions. Often, the shares are transferred to the employee at little or no cost but are subject to forfeiture if the employee fails to fulfil the terms of the plan. A common restriction requires employees to forfeit the shares if they terminate employment within a certain number of years.

Restricted stock is particularly useful when the owner wants to reward a key employee with an equity ownership in the company in recognition of past efforts or in anticipation of future services, but is unwilling to give immediate unrestricted ownership. The arrangement can be structured so the employee earns ownership of the stock over time, yet obtains the economic benefits (i.e., the opportunity to participate in the stock's appreciation) and voting rights of the shares immediately.

Restricted stock may also be appropriate when the company expects significant future growth in the stock value but needs all available corporate cash flow to fund this growth. A restricted stock program allows the key employee to benefit from the stock appreciation during the company's growth period without forcing the company to use any of its cash reserves.

The major drawback of restricted stock from an employer's perspective is that the employee does not necessarily have an incentive to perform at any particular level in order to receive the benefit. Unlike stock options or stock appreciation rights (SARs), where the value to the employee comes with stock appreciation, restricted stock is often a valuable benefit when transferred to the employee. If the company is in a "mature" phase (i.e., does not expect significant future growth in its stock), the bulk of compensation benefit has already been realized. All the employee has to do is remain with the company for the period covered by the restriction in order to receive it. A restricted stock award is best used to recognize past achievements and as a financial incentive to remain with the company. However, it will not necessarily motivate employees to excel in the future.

Income Tax Implications of Restricted Stock

When restricted stock (i.e., stock subject to a forfeiture risk) is transferred to the employee as payment for services, the employee's income and the employer's deductions are not recognized until the stock is no longer restricted, unless the employee makes an IRC Sec. 83(b) election to recognize the income at the date of receipt. If the Section 83(b) election is not made, the excess of the stock's FMV at the time the restrictions lapse over the amount paid (if any) is taxed as compensation income. The employee's holding period for the stock begins the date the restrictions lapse.

An employer generally cannot deduct the restricted stock's value as compensation until the year the employee's tax return includes such compensation as income (Venture Funding Ltd.). However, employers can avoid losing the deduction using the "deemed inclusion" safe harbor by reporting the compensation on Forms W-2 or 1099. Note further, however, that in Robinson, the court held that an employer's deduction should be based on the amount legally required to be included in the employee's income, regardless of the amount actually included or whether a Form W-2 or Form 1099 was issued.

Stock is restricted stock (i.e., is substantially nonvested) when *both* of the following conditions are present:

1. **The Stock Is Subject to a Substantial Risk of Forfeiture Stock** is subject to a substantial risk of forfeiture if the rights to its full enjoyment are conditioned (directly or indirectly) upon (1) the future performance (or lack of performance) of substantial services by the employee or (2) the occurrence of a condition related to a purpose of the transfer (for example, a requirement that the executive obtain a professional designation or attain a certain job position within the company).

2. **The Stock Is Not Transferable** Stock is transferable if the executive can transfer any interest in the stock to any person other than the employer, and the transferee's rights in the stock are not subject to a substantial risk of forfeiture. Therefore, the stock is *not* transferable if the employee can sell, assign, or pledge his interest in it to any person other than the employer but the other person is required to give up the stock or its value if the event causing the substantial risk of forfeiture occurs.

The key is whether the stock is subject to a substantial risk of forfeiture. The second condition (nontransferability) simply ensures that, if the employee transfers the stock, the transferee will also be subject to the substantial risk of forfeiture condition.

A restricted stock plan is a written agreement between the employee and the company. Key provisions that should be in the plan include the following:

- The number of shares and the type (voting, nonvoting, common, preferred, etc.) to be granted.
- A statement that full enjoyment of the shares is dependent on the performance of future services by the employee (i.e., a definition of the risk of forfeiture).
- A schedule of the dates on which the stock restrictions lapse.
- Restrictions on transfer indicating that the shares cannot be sold, transferred, or otherwise disposed of or pledged in any manner by the employee during the term of the agreement. However, to alleviate employee concerns about a possible sale of part or all of the company, the company may want to provide special provisions (such as immediate vesting or an increase in the number of shares available) that are activated if a sale takes place.
- The employee's rights with respect to dividends and voting rights, including whether the employee is entitled to all dividends and voting rights on the restricted shares. Company owners sometimes wish to restrict voting rights by issuing nonvoting stock or requiring the stock to be held in a voting trust while the restrictions are in force.

Incentive Stock Options (ISOs)

Like restricted stock awards, ISOs can provide key employees additional compensation through the opportunity to share in the appreciation of the company's stock value. Although there are other ways to allow key employees to participate in the company's success (e.g., profit sharing plans or ESOPs), these types of plans prohibit the employer from limiting participation to key employees. An ISO can be tailored to reward only those key employees the owner is attempting to retain.

Neither the grant nor the exercise of an ISO creates compensation income to the employee, although the employee will have an alternative minimum tax (AMT) adjustment upon exercise of the option. In addition, FICA and FUTA tax does not apply to the excess of the stock's fair market value (FMV) at the exercise date over the exercise price. The employee recognizes income or loss only when disposing of stock acquired through the exercise of the option. Under an ISO plan, the company generally receives no tax deduction.

Incentive stock options usually are granted to the employee at no cost. Therefore, the employee is not required to invest any capital at the date of grant and thus has no significant downside risk if the company stock declines in value before the option is exercised. If the stock price drops below the exercise price, the employee simply chooses not to exercise the option. However, if the stock appreciates, the employee must use his or her funds to exercise the option.

To qualify as an ISO, the option must be granted under a plan that meets the following statutory requirements:

Approved Plan The stock option must be granted pursuant to a plan (approved by shareholders within 12 months before or after the plan's adoption) that specifies the total number of shares that can be acquired by exercising ISOs and identifies the employees, or class of employees, that may be granted.

Grant and Exercise Date Deadlines The option must be granted within 10 years from the earlier of the adoption or shareholder approval of the plan and must be exercised within 10 years of when the option is granted.

Nontransferable The option cannot be transferable by the option holder other than at death, and the option can only be exercised, during his lifetime, by the option holder. However, the ISO holder's estate is permitted to exercise options. The ISO agreement can also give the ISO holder the ability to designate beneficiaries who would be able to exercise the options after his death. In addition, the legal representative of a disabled option holder is permitted to exercise options on behalf of the disabled option holder.

Minimum Exercise Price The exercise price must equal or exceed the stock's FMV at the time the option is granted.

10% Related-party Restriction The option cannot be granted to an employee who owns more than 10% of the corporation [determined under the attribution rules unless the option price is at least 110% of the FMV of the stock and the option expires no later than five years from the date of grant.

Annual Exercise Limit The total FMV of stock for which options are first exercisable by any individual during a calendar year cannot exceed $100,000. FMV is determined on the option grant date. (All ISO plans of a corporation, its parent, or its subsidiary are treated as one plan.) If the $100,000 limit is exceeded, only options on stock in excess of the limit fail as ISOs. Instead, they are considered nonqualified stock options (NQSOs).

Employment Requirement The option must be granted to an employee of (a) the granting corporation, (b) a parent or subsidiary of the granting corporation, or (c) a corporation that assumes the options by reason of a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation, or a parent or subsidiary corporation of such corporation. Generally, the option holder must be an employee from the date of grant through the date of exercise. Exceptions to this employment requirement are provided for options exercised (a) within three months after termination of employment for any reason, (b) within one year after termination of employment because of disability, or (c) by the employee's estate or other person who acquired the right to exercise the option by reason of the employee's death.

If the plan fails to meet the above requirements, the option will be treated as a nonqualified stock option. The status of an ISO is determined when the option is granted. Since modification, extension, or renewal of an ISO is treated as issuance of a new option, all ISO requirements must be met again on the date an ISO is modified, extended, or renewed.

Generally, there are no adverse tax consequences to the corporation if the option does not qualify as an ISO since it does not receive a tax deduction if the ISO requirements are met. However, the employee may be subject to adverse tax consequences if the option fails to qualify as an ISO since a portion of the value could be taxed as ordinary income when the option is exercised, rather than as all capital gain when the stock is sold.

Several of the ISO requirements are quite restrictive and should be carefully evaluated before the decision is made to offer ISOs to key employees. These restrictions are discussed in the following paragraphs.

Minimum Exercise Price Requirement The requirement that the exercise price must equal or exceed the value of the stock at the time of grant makes an ISO attractive only if the stock is expected to substantially appreciate in value.

In addition, the minimum exercise price requirement requires the company to make a good faith effort to value its stock. Obtaining an accurate value may not be a simple process for a closely held business. If this is a concern, the closely held business owner may want to consider issuing nonqualified stock options instead.

10% Related-party Restriction An option will not qualify as an ISO if, when the option is granted, the grantee owns stock possessing more than 10% of the total combined voting power of all classes of stock of the employer corporation. However, an exception to this rule exists if, when the option is granted, the option price is at least 110% of the FMV of the stock and the option is not exercisable after the expiration of five years from the date the option is granted. In essence, while key employees owning more than 10% of the company stock may participate in the ISO plan, they must pay a price for that opportunity in the form of a higher exercise price and a shorter growth period for the ISO option.

Annual Exercise Limit There is no limit on the number of shares that may be acquired through an ISO. However, the plan must be designed so that options to acquire no more than $100,000 of stock become exercisable in any year. This limit is based on the value of the stock at the grant date. If the $100,000 threshold is exceeded, the options attributable to stock over the limit are treated as nonqualified stock options.

Tax Consequences of an ISO

Income Tax For regular tax purposes, an employee recognizes income when the stock acquired by exercising the ISO is sold. The amount of income is the difference between the employee's regular tax basis in the stock (the exercise price) and the stock's sales proceeds. The income's character depends on whether or not the executive meets the ISO holding period requirement. The holding period requirement is met if the employee does not dispose of stock acquired by exercising an ISO during the two-year period following the date of grant or within the one-year period following the exercise date. If the holding period requirements are met, the recognized income is taxed as capital gain. If the holding period requirements are not met, the option spread [difference between exercise price and the lesser of (a) the FMV of the stock when the options are exercised or (b) the amount realized on the disposition] is taxed as ordinary (compensation) income to the employee, and any income above the option spread is taxed as capital gain. A disposition of stock before the required holding period is known as a disqualifying disposition. A taxpayer must recognize the income resulting from a disqualifying disposition in the year the stock was sold even though payment for the stock was to be made in installments and was partially conditioned on the taxpayer's continued employment with the company.

The company receives a deduction for the ordinary income the employee recognizes as a result of the disqualifying disposition. The deduction is taken in the corporation's year that includes the date of the disqualifying disposition. The company does not receive a deduction for any capital gain the employee recognizes.

Nonqualified Stock Options (NQSOs)

A nonqualified stock option (NQSO) is an option that specifically states it is an NQSO or one that does not meet the requirements of an incentive stock option (ISO). NQSOs are more flexible than ISOs.

Like an ISO, employers can use an NQSO to provide key employees additional compensation through the opportunity to share in the appreciation of the company's stock value. NQSOs, like ISOs, generally require the employee to use cash to exercise them. Although the tax treatment of an NQSO is somewhat less favorable to the employee than for ISOs, an NQSO may be viewed more favorably by the employee because it can establish an option price that is below the stock's value, allowing the employee to obtain an immediate compensation benefit if the option is exercised. In addition, the company receives a deduction for the compensation realized by the employee.

Nonqualified stock options are not subject to the numerous restrictions placed on incentive stock options. Under a nonqualified stock option plan, there are no limits on the amount of options that can be exercised, no time period limitations during which the options must be granted or exercised, and no restrictions on transferability of the options. Perhaps most importantly, unlike an ISO, there is no requirement that the option price equal the stock value at grant date, or that, for employees owning more than 10% of the stock, the option price equal 110% of the stock value at the grant date. Therefore, nonqualified stock options are frequently granted with an exercise price that is substantially below the fair market value at the grant date. NQSOs granted at an exercise price below market price are called discounted or "in-the-money" stock options.

The tax consequences of an NQSO to the employee and the employer are follows:

- If an NQSO has a readily ascertainable FMV on the date of grant, its value is included in the employee's income at the date of grant unless the option is subject to a substantial risk of forfeiture or is not transferable. The FMV of an NQSO is not readily ascertainable unless the option is actively traded on an established securities market or it meets all of the following conditions:

    1. The option may be transferred freely.

    2. The option is exercisable immediately in full by the recipient.

    3. There are no restrictions on the option or the stock that have a significant effect on the FMV of either.

    4. The FMV of the "option privilege" is readily ascertainable.

    Observation: It is very rare for the IRS to consider an option not traded on an established securities market to have a readily ascertainable FMV. Therefore, NQSOs of a closely held business will not usually result in income to the employee at the date of grant.

- If the option has no readily ascertainable FMV at the date of grant, tax consequences occur when the option is exercised if the stock received is substantially vested. Stock received upon exercise of an option is substantially vested unless it is subject to a substantial risk of forfeiture and is not transferable. If the stock purchased by exercising the option is substantially vested, the difference between its FMV and the exercise price of the option is included in the employee's income at the date of exercise. If the stock is restricted, the difference between the FMV of the stock when it vests and the exercise price of the option is included in the employee's income when the restriction lapses, unless the employee elects to recognize the income when the option is exercised by making an 83(b) election.

- The employee's stock basis is the FMV of stock when exercised.

- The employer is allowed a compensation deduction in its tax year that includes the end of the employee's tax year in which the compensation is taxable, provided the compensation is properly reported on the employee's Form W-2. Income and employment taxes are due on this noncash compensation.].

- If a NQSO is transferable, the employee may be able to avoid or reduce estate and gift taxes by gifting [must be a completed gift the option to a family member. The option's value as a gift is its FMV on the date of the gift. The transfer of a stock option to a family member does not cause the recognition of taxable income or gain to the employee. Ideally, the transfer will be made shortly after the NQSO grant and the gift will be valued well below the stock price when the option is eventually exercised. Any appreciation in the value of the option subsequent to gifting will be removed from the employee's estate and will not be subjected to additional estate and gift taxes. The initial gift is subject to gift tax and the related amount paid cannot be recovered if the family member never exercises the gifted option. When the family member recipient exercises the option, the employee donor will recognize ordinary income (subject to taxation) equal to the FMV of the stock less the exercise price. Any income taxes paid further reduce the employee's taxable estate for estate tax purposes without the imposition of a gift tax.

Comparing the Tax Benefits of ISOs and NQSOs

While ISOs often produce more favorable tax results for the employee, NQSOs can be a more flexible compensation planning tool, with as good or better tax results in the right circumstances. The proper approach is to determine which plan best fits the employee's compensation goals and is consistent with the relevant financial and tax considerations. In some cases, an ISO will be the obvious choice. In others, an NQSO may provide better economic, tax, and financial results.

When to Use an ISO. An incentive stock option may be appropriate if:

- **The Stock's Value at Grant Date Is Ascertainable** The requirement that the exercise price of incentive stock options be no less than the stock's value at the grant date makes it impossible to use ISOs if the company is not willing or able to establish the stock's value at the grant date. For a closely held company, establishing the stock's FMV may be a timely and costly process.

- **The Shares Have Potential for Substantial Future Appreciation** The requirement that the exercise price of incentive stock options be no less than the stock's value at the grant date makes ISOs relatively unattractive if the stock's value does not have good potential for future appreciation. This requirement also means there is no immediate compensatory benefit to the recipient of an ISO. Instead, to benefit, the employee must rely on future appreciation beginning at the grant date.

- **The Employee's Marginal Tax Rate Greatly Exceeds the Capital Gain Rate** With an ISO, the employee is able to avoid compensation income and enjoy capital gain treatment (assuming no disqualifying dispositions) for all appreciation in the value of ISO stock from the grant date. If the employee's marginal tax rate on ordinary income is high in comparison to the long-term capital gain rate, an ISO plan can save a substantial amount in taxes on this stock appreciation.

When to Use an NQSO. A nonqualified stock option may be appropriate if:

- **The Option Is Granted at a Discount from FMV** An employee may view a nonqualified stock option more favorably than an ISO because the option price can be set at a nominal amount, or at least at a price substantially below FMV. Thus, the employee needs less cash to exercise a nonqualified stock option. Furthermore, the option price can be set low enough to provide the employee with an immediate benefit at the date of grant. The fact that the option price can be below FMV is also important if it is impractical to establish the stock's FMV at the grant date.

- **The Employee Owns More Than 10% of the Company's Stock** An ISO cannot be granted to anyone owning more than 10% of the company's stock unless the exercise price is at least 110% of the stock's FMV and the exercise period is limited to five years. These restrictions may discourage the use of ISOs in closely held corporations.

- **The Company Desires a Tax Benefit** The employer gets a deduction under both a nonqualified stock option plan and an incentive stock option plan equal to the amount of ordinary income recognized by the executive. However, in an ISO plan the employee recognizes ordinary income only if the stock is sold in a disqualifying disposition. Therefore, the company cannot control whether or not it will get a deduction. In an NQSO plan, the company's deduction is assured.

- **The Company Wants to Maximize Cash Flow** Because of the tax benefit, a profitable company should be better off in terms of cash flow using nonqualified stock options rather than ISOs. Although an ISO saves the employee the difference between the ordinary income tax rate and the long-term capital gain rate, the employer is generally forgoing a deduction worth 34% or 35% (the employer only gets a tax deduction if the employee recognizes ordinary income). Thus, an employer could offer nonqualified stock options, compensate employees for the tax difference between those options and ISOs, and still come out ahead.

- **The Company Is Unwilling to Incur Significant Compliance Costs** Nonqualified stock options are flexible and are free from the many restrictions that burden ISO plans (e.g., ISOs must be granted pursuant to a plan, grant and exercise deadlines exist, there is an annual exercise limit).

- **The Employee Desires to Reduce Estate and Gift Taxes** If the NQSO is transferable, the employee may be able to avoid or reduce estate and gift taxes by transferring the option to a family member.

Use of Equity-based Compensation by Entities Other Than C Corporations

The stock-based compensation programs discussed previously would not work for partnerships or limited liability companies (LLCs) trying to retain key employees since neither of these types of entities has stock that can be given to employees or upon which options can be issued.

Many partnerships and LLCs do, however, reward employees by giving them partnership or LLC interests for their services. An employee who receives an unrestricted capital interest for the performance of services recognizes taxable income. A capital interest is an interest that would give the employee a share of the proceeds if the LLC or the partnership's assets were sold at FMV and the proceeds were distributed in a complete liquidation. If the transfer of an unrestricted capital interest is made for past services performed by the employee, the amount of income recognized is equal to the FMV of the interest at the time of transfer. If the transfer is conditioned on the completion of future services by the employee, the income recognized equals the FMV of the interest at the time the services are rendered.

In contrast to the taxability of the receipt of a capital interest, the receipt of a profits interest (i.e., an interest that is not capital interest) in a partnership or LLC generally is not a taxable event.

Usually, whether an interest is a profits or capital interest is determined when the service provider receives it. However, if all the following conditions are met, the determination is made when the interest is granted, even if substantially nonvested at that time:

- Both the partnership and the service provider treat the service provider as the owner of the partnership interest from the date of grant and the service provider includes his or her distributive share of partnership items in taxable income for the entire time the interest is held.

- The partnership (or its partners) does not deduct the FMV of the interest as compensation either when the interest is granted or when it becomes substantially vested.

Despite the general rule, the receipt of a profits interest may be taxable if:

- The profits interest relates to a substantially certain and predictable stream of income from the partnership or LLC assets (such as a net lease),

- Within two years of receipt, the employee disposes of the profits interest, or

- The profits interest is a limited partnership interest in a Section 7704 publicly traded partnership.

PROVIDING CASH INCENTIVES BASED ON COMPANY VALUE

Frequently, business owners do not want to dilute their ownership by transferring an interest in the company to outsiders. In these cases, stock-based compensation programs are not a viable way of enticing key employees to stay, since they involve transferring shares of stock or stock-related rights. There are, however, equity-oriented programs that do not result in the transfer of actual stock. These programs provide cash compensation determined by reference to the company stock value. Although actual shares of stock are not transferred, the employee is compensated if the stock's value increases. Compensation tied to the value of a company's stock can provide the employee an incentive to maximize stock value. However, it can also provide additional compensation to the employee merely due to inflation (i.e., the value of the company increases without any effort on the employee's part). Employers should consider this when determining how the value of the stock will be measured under the plan.

Two common equity-oriented plans are stock appreciation rights and phantom stock arrangements.

Stock Appreciation Rights

A stock appreciation right (SAR) is the right to receive compensation based on the increase in value of a specified number of the employer's shares of stock. When an SAR is exercised, the company usually pays the employee cash equal to the stock's appreciation, although payment can be made in shares equal in value to the appreciation. Because employees do not have to spend any cash to benefit from the plan, they may prefer an SAR to a stock option, which typically requires the employee to use cash to exercise. However, the employee does not receive (or get credit for) any dividends paid on the company's outstanding shares.

In a typical SAR arrangement, the key employee receives an assumed base investment equal to a certain amount of the corporation's stock as of a certain date (e.g., 10% or 1,000 shares of the company's stock). The assumed investment is valued at a specified price. (Many closely held businesses use current book value as the specified price.) Upon termination of the agreement or sale of the company, the key employee receives compensation equal to the appreciation in the assumed investment. The appreciation is measured by the difference between the stock's specified price on the agreement's expiration date or company sale date and the specified price on the date of the agreement. The agreement's termination date is usually tied to specific events (such as the employee's retirement, death, termination from the company, or a specified period of time). In addition, the employee can terminate the agreement by giving written notice to the corporation (usually after some type of vesting period) that he is exercising his rights under the agreement. Employees normally cannot exercise less than the full amount of the SAR unless the agreement makes a provision for a partial exercise. The compensation (i.e., appreciation) may be paid in a lump-sum, installments, or combinations thereof. Interest is generally paid on any unpaid installment balance.

SARs can be granted as a separate benefit or in tandem with an incentive stock option or a nonqualified stock option. Granting SARs in tandem with ISOs or NQSOs helps alleviate the liquidity problem associated with exercising options (i.e., the employee has to pay for the stock when the options are exercised but may not have the cash to do so unless the acquired stock is immediately sold). If the SAR is exercised instead of the stock option, the company pays the employee an amount equal to the appreciation of the stock covered by the option. It can be made in cash, stock, or a combination of both. When the SAR is exercised, the related stock option may be canceled (or if the stock option is exercised, the SAR would be canceled). Thus, the executive has the choice of exercising the option and getting stock or exercising the SAR and getting cash. Alternatively, the plan may allow the participant to exercise both the option and the SAR, which can provide cash to exercise the options and pay the related taxes without selling the shares.

Income Tax Consequences The net value of the SAR is taxed to the employee as compensation income when the cash is received unless the employee is in constructive receipt or realizes an economic benefit at an earlier date. The compensation income is subject to Federal income tax withholding and employment taxes. The corporation deducts the amount of compensation income when it is recognized by the employee.

Estate and Gift Tax Planning If the SAR is transferable, the employee may be able to avoid or reduce estate and gift taxes by gifting (must be a completed gift) the SAR to a family member. The SAR's value as a gift should be its FMV on the date of the gift. Transferring the SAR to a family member should not cause the recognition of taxable income or gain to the employee. Ideally, the transfer will be made shortly after the SAR is granted and the gift will be valued well below the value when the SAR is eventually exercised. Any appreciation in the value of the SAR subsequent to gifting will be removed from the employee's estate and will not be subjected to additional estate and gift taxes. The initial gift is subject to gift tax and the related amount paid cannot be recovered if the family member never exercises the SAR. When the family member recipient exercises the SAR, the employee donor will recognize as ordinary income (subject to taxation) the value of cash or other property received by the family member. Any income taxes paid further reduce the employee's taxable estate for estate tax purposes without the imposition of a gift tax.

Phantom Stock Plans

A phantom stock plan can replicate the benefits of a restricted stock arrangement without transferring actual shares. Under a typical phantom stock plan, each participant's account is credited with a stated number of stock units as of a certain date. Each unit is equal in value to a share of employer stock. (Many closely held businesses use current book value to measure stock value.) A phantom stock award is outstanding for the period specified in the plan. At the end of that period, the key employee receives compensation equal to the value of either the stock units or to the stock units' appreciation, measured by the difference between the value of the stock units at the end of the agreement and their value on the date of the agreement.

During the period the phantom stock agreement is in effect, the plan may allow the key employee to either receive or be credited with any dividends paid on the company's shares. At the end of the award period, the employee receives any dividends credited, along with either the value or the appreciation in the value of the stock units. These amounts can be paid (using cash or stock; however, it is usually in cash) in a lump-sum, installments, deferred until a future date (e.g., retirement or other service termination), or combinations thereof. For example, a company may structure an agreement to pay upon exercise 25% of the amount due and the remaining 75% in monthly or annual installments. Interest is generally paid on any unpaid installment balance. Phantom stock awards can be subject to vesting provisions (e.g., if the employee leaves the company within 10 years, rights to the phantom stock are forfeited).

Phantom stock plans are similar to SARs in that the participant's compensation is based on the company's stock appreciation and that employee cash is not required to participate in the stock appreciation. However, phantom stock plans are usually established for a fixed amount of time whereas a SAR's termination date is normally tied to specific events (e.g., the employee's retirement, death, or termination from the company). In addition, the employee can exercise an SAR by giving written notice to the corporation (usually after some type of vesting period). A phantom stock plan does not usually allow the employee to exercise his rights under the agreement before the end of the award period. The biggest difference between an SAR and a phantom stock plan is the phantom stock plan may credit the employee with any dividends that are paid on the company's outstanding shares. SARs do not have this feature. However, since closely held companies do not usually pay dividends, this difference may not be significant.

Performance Share Phantom Stock Plans Performance shares are similar to restricted shares except that they become unrestricted if the company achieves certain strategic targets during a stated measurement period. By awarding performance shares, the employer can tie executive compensation directly to company performance, giving the executive the incentive to meet specific targets. For the executive, the biggest downside to performance shares is that the targets may not be achieved for reasons beyond the executive's control, leaving the executive with nothing.

The performance targets can be determined in any manner the company chooses and often include growth in earnings per share, return on equity or return on assets targets, or attainment of specific sales, profit, or expense reduction goals.

Income Tax Consequences of Phantom Stock Plans The employee recognizes compensation income upon receipt of the payment, unless income was constructively received or an economic benefit was realized at an earlier date. The corporation deducts the amount of compensation income recognized by the employee. The compensation income is subject to withholding and the payment of employment taxes. Because a phantom stock plan is considered a nonqualified deferred compensation plan for payroll tax purposes the payroll taxes are payable as of the later of when the services are performed or when there is no longer a substantial risk of forfeiture (e.g., when benefits vest) with regard to the employee's right to receive payments under the plan.

Estate and Gift Tax Planning If the ownership unit received in a phantom stock plan is transferable, the employee may be able to avoid or reduce estate and gift taxes by gifting (must be a completed gift) the unit to a family member. The unit's value as a gift should be its FMV on the date of the gift. Transferring the unit to a family member should not cause the recognition of taxable income or gain to the employee. Ideally, the transfer will be made shortly after the unit is granted and the gift will be valued well below the value when the unit is eventually exercised. Any appreciation in the value of the unit subsequent to gifting will be removed from the employee's estate and will not be subjected to additional estate and gift taxes. The initial gift is subject to gift tax and the related amount paid cannot be recovered if the family member never exercises the unit. When the family member recipient exercises the unit, the employee donor will recognize as ordinary income (subject to taxation) the value of cash or other property received by the family member. Any income taxes paid further reduce the employee's taxable estate for estate tax purposes without the imposition of a gift tax.

Determining Stock Value in a Closely Held Business

The benefit provided by both SARs and phantom stock is based on the stock's value when the plan is terminated. However, value does not have to be based on the market value of a company's stock. Some other measure can be used to determine the value of the awards. Many closely held businesses use book value as a measure of value for SARs and phantom stock. Book value is used because it is readily determinable at the end of each fiscal year, and its determination does not entail additional administrative time or professional appraisal expenses. (It is often difficult and sometimes costly to estimate the FMV of stock in a closely held business.) As an alternative, valuation consultants can recommend valuation formulas that may be appropriate for a particular business. By using a predetermined formula to value the stock, the parties can minimize costs associated with determining the market value of shares in a closely held business.

Care must be taken to ensure the formula used to determine value does not produce unreasonable results. The goal is to reward the employee for real economic growth in the company's value. The corporation's cash flow must be sufficient to fund the future amounts due the employee. In addition, the corporation must consider the possibility that the measure of value might increase more or less rapidly than anticipated, thereby creating too much or not enough compensation incentive for the key employee.