

Performance Compensation Practices and the Development of an Ownership Culture

Equity-based compensation without the transfer of actual Stock (or Partnership Interest)

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By W. Terence Jones and Christopher Becker

Business owners regularly assert a common challenge: effectively motivating employees to attain and sustain profitability and grow the company. A conventional feature of successful businesses is the encouragement of an entrepreneurial spirit in its employees, where the employees are focused on individual and company performance; in other words, the employees think like an owner. This characteristic is an aspect of what we call an ownership culture.

Revenue sharing is a common feature of the ownership culture as it results in a win-win for both the owner and the employees -- since the employees only receive a share of profits upon the company's receipt of revenue in excess of expenses, they clearly have a goal to increase the profitability of the company. "Phantom equity" compensation is a form of revenue sharing.

Phantom equity refers to certain types of compensation which simulates the value of a predetermined number of shares of the company (or interests in a partnership) over a specific period of time. Phantom equity is an unsecured promise represented by a unit which corresponds to an equivalent ownership interest. Consequently, such awards are designed to reward performance without the actual issue of shares or other ownership interests.

Performance-based Compensation

In an ownership culture, employees understand how the business works, and are effective in identifying the goals of the business and measuring the outcomes. Essential to sustain leadership in a business is the recruitment and retention of talent. There are various tools to identify and retain top talent: these include training, performance reviews and compensation. It is commonly asserted that compensation in all its forms serves as a measure of the value that the employer places on the employee, and a motivator for staying in a job (or for leaving it).

Equity-based compensation gives employees a financial and psychological stake in the company. Phantom equity plans typically condition the receipt of the award on the attainment of certain targets or

other vesting conditions, such that any unvested portion of the award is forfeited if the employee terminates. Phantom equity programs can be designed to reward the performance of divisions or subsidiaries.

Stock Appreciation rights

Stock appreciation rights provide the employee the right to receive the increase in value of the stock of the company. Each stock appreciation right (SAR) is represented by a unit which corresponds to an equivalent share of stock. When the employee exercises the right, he or she receives the difference between the grant price of the stock and the market value of the stock at the time of exercise. (SARs may also be structured to pay the



Simulated Equity in a Partnerships or LLC

Like corporations, partnerships and LLCs may issue appreciation rights on the value of the partnership or membership interests. Ownership of a partnership's interests may also be shared. Partnerships may issue "profits interests" which provide employees with rights to allocation of a certain percentage of the earnings on the membership interests. The partnerships also will not generally be subject to tax in connection with the transfer of a compensatory partnership interest.

Currently, the profits allocated to the grantee retain the character of such profits earned by the partnership. Thus, if the partnership generates capital gain, the grantee would recognize capital gain. The Obama administration, however, has released a revenue proposal which would treat the income attributable to a service partnership interest as ordinary income and subject to the self-employment tax, even though historically capital gain treatment applies in some cases.

Matters to review in Designing the Phantom Equity Compensation Plan

Phantom equity can facilitate the flexible design of long-term incentives. Certain matters to review include --

- whether the the award is focused on the value of the performance and continuity of revenue (and state of the company), e.g., subject to a vesting schedule;

spread on a fixed settlement date.) Since SARs give the employee the appreciation in value of the company stock, **such awards will not dilute the ownership in the company.** SARs do not include dividend payments.

When the SAR is exercised and payment of the spread is made, the company receives a deduction for the award. Since SARs are typically settled in cash, companies will have to address the payment obligations:

- will the company put aside the funds?
- if so, the funds could be subject to the accumulated earnings tax;
- the company may settle the SAR in stock if it has insufficient funds the pay the SAR (where the number of shares transferred will be determined on the total amount of the appreciation divided by per share value at the time of exercise).

SARs are exempt from the deferred compensation rules under Section 409A of the Internal Revenue Code, provided that each stock unit (upon which the SAR is based) is granted at the fair market value the underlying share of stock.¹

Phantom Stock awards

Phantom stock provides a bonus based on the value of a stated number of shares. Each Phantom stock unit represents a share of stock. Unlike SARs, which may be structured to avoid falling under the parameters of Code section 409A, phantom stock is deferred compensation, subject to Section 409A. Section 409A include rules specifying the time of payment at the time of grant and prohibition on the acceleration of distributions.¹

¹ If the Stock award is distributed in violation of the parameters of Section 409A, the employee is taxed on the award and subject to a 20% excise tax plus the employer is subject to a penalty for failure to withhold Federal taxes accordingly.

- whether the award is based on growth targets; if so, the award is an achievement and not an entitlement;
- what amounts will cause the employees to think about the metrics of the company;
- what is the degree of difficulty in achieving goals;
- who will receive the Phantom equity – practitioners suggest giving the awards broadly, as this will involve everyone in the incentive program, encouraging a group effort among the employees to promote the overall growth of the business; and
- whether the program should include other covenants, e.g. a "change in control" provision.

For further information on equity compensation arrangements, please feel free contact us 617-451-1500.



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Terry Jones is a founding member and partner of Maselan & Jones. He has over 25 years of experience in the Employee Benefits area. He received his B.A. from Yale University and received his law degree *cum laude* and a Masters of Law in Taxation from Boston University School of Law.

Maselan & Jones, P.C.
One International Place
Boston, MA 02110

Phone:

617.451.1500

Fax:

617.451.5174

Visit us at:

www.MaselanJones.com

Chris Becker has been practicing law for 8 years. Chris received his B.B.A. from the University of Notre Dame, and earned his law degree from Duquesne University School of Law and Masters of Law in Taxation from Georgetown University Law Center along with the Certificate in Employee Benefits.