EQUITY INCENTIVE COMPENSATION AND SUCCESSION PLANNING: PART I: STOCK OPTIONS AND OTHER INCENTIVE COMPENSATION STRUCTURES FOR THE CLOSELY-HELD BUSINESS

What is the best way to incentivize employees and create a form of ownership succession plan in a growing, privately-held business? Many clients ask us this, but we don't always give the same answer. The right incentive compensation structure may depend on the ease of implementation for the particular company, employee expectations, and plans for future growth. Business owners also look for ways to transition ownership of their closely-held companies to the insiders or family members they have identified as the next leaders.

Most businesses are familiar with stock option plans, which for decades now have been a standard part of employee compensation in the technology industry and in many other businesses. For many businesses, option plans can create a strong incentive tool to motivate and retain employees, and many employees expect or even demand stock options as part of their compensation packages. Option awards in a small business can result in value for employees when the business is subsequently acquired, but often not when the company's founders intend to hold the company and pass along ownership to their family members or close associates. In that case the business may need a succession ownership plan, implementing a means for the transition of ownership and control to new leaders, and it may need another form of incentive compensation structure in order to provide an effective form of incentive compensation to its employees.

In the sections below, this article reviews the most familiar type of incentive compensation structures, option plans and the types of option awards granted under those plans, along with some commonly used alternative incentive structures.

In Part II of this series, we review succession planning, considering different methods for transition of stock ownership to other family members or a new class of owner-operators for the closely-held business.

Overview of Option Plans and Other Forms of Incentive Compensation Plans

The Stock Option Plan is probably the most familiar type of equity incentive compensation plan that a company might adopt. Nevertheless, the company might consider other incentive compensation structures to enable its employees and others (consultants, advisors, contractors, family members) to share in the increase in value of the company over time and/or to enable to the controlling owners to transition ownership of the company to a new leadership team. Popular alternatives to stock options include the following:

- *Restricted Stock Grants* – grant of shares of stock; subject to vesting; subject to restrictions on transfers; taxable at time of lapsing of restrictions; treated as full stock for voting purposes, dividend rights.

- *Restricted Stock Units (RSUs)* – preferred by many larger companies - subject to vesting, in most plans shares granted at and subject to tax on vesting.

- *Stock Appreciation Right (SARs)* – allows recipient to accrue a right to a cash award equal to a percentage in the growth of the company's value above a current value, payable at a liquidity event or possibly an annual benefit. More common in larger companies.

- *Profits Interests*. Companies structured as LLCs can grant profits interests to employees or others. When structured correctly, profits interest cause no tax to the recipient on grant and give the recipient the opportunity to share in the growth of the company's value.

- *Phantom Stock Plans*. Many businesses choose not to implement an actual formal equity plan such as one of the above but instead create a "phantom stock" plan. These plans create units of interest that track the increase in value of the company but do not result in the recipients holding any true equity ownership interest in the company.

- *Bonus Compensation Plans*. Many businesses choose to implement cash bonus plans, based on a variety of factors and metrics.

OPTION PLANS AND STOCK OPTION GRANTS GENERALLY

The option plan is a familiar type of equity compensation plan to incentivize employees, although it may be more appropriate or more commonly used in a corporation that expects significant growth and a public offering or acquisition by a public company down the road. Options give their recipients the right to buy shares of common stock at some point in the future, at a pre-set price (the "exercise price"). The option exercise price must be set at the fair market value of the common stock at the time of grant.

There are generally two types of stock options: nonqualified or nonstatutory stock options ("NSOs") and incentive stock options ("ISOs"). There are certain tax advantages to having a stock option qualify as an incentive stock option and special requirements must be met for an option to be considered an incentive stock option. If these requirements are not met, the option would be treated as a nonqualified option. (If an option that was intended to be an ISO was exercised and underlying stock is sold in violation of certain of the requirements governing ISOs, the transaction is called a "disqualifying disposition".)

Nonqualified Stock Options ("NSOs")

In the case of an NSO, the holder of the option is generally subject to tax at *ordinary income tax rates* when he or she exercises the option. The tax is imposed on the excess of the fair market value of the stock received at the time of exercise over the exercise price, plus any amount the employee paid for the option. Because an employee generally receives the options for free, the tax is usually imposed on the excess of the fair market value of the stock at the time of exercise over the exercise price. (Generally the employee will not pay anything for the option.)

Ordinary income is taxed at marginal rates up to the highest marginal Federal rate of 37% for 2020. In addition to Federal income tax, there are state income taxes (up to 13.3% in California) plus social security taxes (12.4% with a wage base limit of $200,000[1], between the employee and the employer, and the Medicare tax under the Affordable Care Act of 2.9%).

If the employee sells the stock for more than the value of the stock at exercise, this further appreciation is treated as a capital gain for U.S. tax purposes. If the stock has been held for at least one year from the time of exercise, this further appreciation is treated as a long-term capital gain and taxed at a lower long-term capital gains rate of 20%, at the most, for U.S. federal income tax purposes. State income taxes would apply to such long-term capital gains (up to 13.3% in California) but social security taxes would not apply to such gains.

[1] See the IRS web page for regularly-updated information on the federal social security tax threshold and related issues: http://www.irs.gov/taxtopics/tc751.html

Incentive Stock Options ("ISOs")

To be an incentive stock option certain requirements must be meet:

- Employees only, not contractors. The option must be granted to the individual in connection with employment.
- The option must be granted within 10 years from the earlier of the date the plan was adopted by the corporation's board or approved by its shareholders.
- The option cannot be exercised after 10 years from the date of grant (or such shorter period as is stated in the incentive stock option grant).
- The option price (i.e. the exercise price) cannot be less than the fair market value of the stock at the time the option was granted.
- The option must be nontransferable (except at death).
- The option recipient cannot own more than 10% of the issuing corporation (or its subsidiary's) voting stock at the time of grant (without satisfying certain rules including an exercise price at least equal to 110% of the fair market value).
- The aggregate fair market value (at the time of grant) of stock for which any employee may be granted incentive stock options from the issuing corporation or its affiliated corporations, that are first exercisable during any one calendar year, cannot exceed $100,000. To the extent this $100,000 rule is violated, only the excess above $100,000 need be treated as nonqualified stock options.
- The employee must remain an employee of the company from the time the option is granted until three months before the option is exercised.
- The plan must meet certain requirements and be approved by the shareholders.

If the options qualify as incentive stock options, the employee recognizes no gain or loss upon the grant or exercise of the incentive stock option. A subsequent sale of the stock acquired upon exercise of the ISO will give rise to a long-term capital gain or loss (assuming certain holding period requirements discussed below are met). A long-term capital gain is taxed at a capital gains rates of 15% or 20% and there are no social security taxes. However, ISOs are also subject to the Alternative Minimum Tax ("AMT"), which can end up taxing the ISO holder on the spread realized on exercise despite the usually favorable treatment for these awards. Still, the taxpayer can have an AMT credit in future years, offsetting tax at that time, which can lessen the overall AMT burden. The 2017 Tax Cuts and Jobs Act reduced the impact of AMT somewhat by increasing the total AMT exemption and the phase-out threshold for AMT, but AMT must still be considered. Also, ISOs may be less beneficial to the company than NSOs from a tax perspective as the company may deduct the compensation expense associated with NSOs but not ISOs. To qualify for the tax benefits of ISOs, the employee must continue to own the shares received on exercise of the ISO for the longer of two years after the ISO was granted or one year after the ISO was exercised. If the employee disposes of the shares prior to satisfying this holding period, he would

generally recognize ordinary income equal to the lesser of (1) the spread at the time the incentive stock option was exercised, and (2) the amount of gain recognized upon the disposition of the stock.

Both ISOs and NSOs may be granted under a single stock option plan. The corporation first adopts the plan (which must be approved by the board of directors and the existing shareholder(s)), and then the board grants options to the employee(s). A stock option agreement (sometimes with an additional Notice of Stock Option Grant) sets forth the terms of the specific grant, which includes the exercise price, the term of the option (it must expire within 10 years) and vesting terms. The option holder has the right to exercise the option in part or in full only as to the number of shares in which he is vested. The vesting structure is determined by the board or delegated to an officer to determine, and it can vary by grantee. Typical vesting terms would be: 4 year vesting, with a 1-year cliff, monthly vesting thereafter over subsequent 3 years. The grant agreement or notice of grant sets forth the exercise price, which must be set at fair market value for the option to be an ISO. NSOs usually are granted at current fair market value as well, to avoid adverse tax consequences.

The tax consequences of and requirements for ISOs vs. NSOs are summarized below:

	ISO	**NSO**
Tax Qualification Requirements:	• The option price must at least equal the fair market value of the stock at the time of grant. • The option cannot be transferable, except at death. • There is a $100,000 limit on the aggregate fair market value (determined at the time the option is granted) of stock which may be acquired by any employee during any calendar year (any amount exceeding the limit is treated as a NSO). • All options must be granted within 10 years of plan adoption or approval of the plan, whichever is earlier. • The options must be exercised within 10 years of grant. • The options must be exercised within three months of termination of employment (extended to one year for disability, with no time limit in the case of death).	None, but an NSO granted with an option price less than the fair market value of the stock at the time of grant will be subject to taxation on vesting and penalty taxes under Section 409A.
Who Can Receive:	Employees only	Anyone
How Taxed for Employee:	• There is no taxable income to the employee at the time of grant or timely exercise. • However, the difference between the value of the stock at exercise and the exercise price is an item of adjustment for purposes of the alternative minimum tax. • Gain or loss when the stock is later sold is long-term capital gain or loss. Gain or loss is the difference between the amount realized from the sale and the tax basis (i.e., the amount paid on exercise). • Disqualifying disposition destroys	* The difference between the value of the stock at exercise and the exercise price is ordinary income. * The income recognized on exercise is subject to income tax withholding and to employment taxes. * When the stock is later sold, the gain or loss is capital gain or loss (calculated as the difference between the sales price and tax basis, which is the sum of the exercise price and the income recognized at exercise).

	ISO	NSO
	favorable tax treatment.	

As a practical matter, many ISO recipients never (or only partially) realize the tax benefits associated with ISOs since they typically do not hold the underlying securities for the one-year minimum period following exercise. In a private company, options are often exercised immediately prior to a sale of the company such that the employee exercises the ISO and then promptly sells the underlying securities along with all other stockholders of the company. Alternatively, ISOs may be cancelled in connection with a sale of the company in exchange for a payment equal to the spread between the sale price and the exercise price. In either case, employees often make the choice not to risk their capital by paying the exercise price for underlying securities prior to a liquidity event, especially in light of the applicability of the alternative minimum tax without a corresponding cash distribution to satisfy the tax obligation. In the context of a public company, the underlying securities are often sold immediately following exercise of the ISO in order to cover (in whole or in part) the exercise price for the ISO (i.e. a cashless exercise). In all situations described above, the employee has short-term capital gain or loss (at rates the same as those for ordinary income) on the difference between the price at which is the underlying security is ultimately sold and the exercise price for the ISO.

Setting Option Strike (Exercise) Price and IRC Section 409A

Section 409A of the Internal Revenue Code applies to deferred compensation arrangements put in place after December 31, 2004, as well as to arrangements previously in place if they were unvested as of that date or were modified after October 3, 2004. Stock options and stock appreciation rights ("stock rights") are Section 409A if (among other circumstances) they were granted with an exercise price *less than* the grant-date fair market value of the underlying stock (a so-called "discounted stock right") or modified in certain respects when the right is "in the money" (i.e., the modification-date fair market value is greater than the exercise price). If a stock right becomes subject to Section 409A, and the strict rules of the statute are not met, then punitive tax consequences apply to the holder (including the risk that the holder would owe income tax, plus significant tax penalties, on vesting even if he or she had not exercised the option or stock right).

Under Section 409A and its regulations, determination of the fair market value of private company stock became more difficult. For a company without stock readily tradable on an established securities market, the fair market value of the stock as of a valuation date means a value determined by "a reasonable application of a reasonable valuation method." The determination of reasonableness is made on a facts-and-circumstances basis, viewed from the valuation date.

The regulations provide that a valuation is *presumed reasonable* if one of the following two methods is consistently applied to grants:

(1) A valuation by an independent appraiser meeting certain requirements (generally, those applicable to appraisals for charitable donation valuation purposes) that is performed within 12 months of the relevant date, assuming there are no subsequent material developments affecting the valuation since it was performed. Companies anticipating an IPO within 12 months will need to do this. Many other private companies also choose this method.

(2) A reasonable good-faith valuation of "illiquid stock of a start-up corporation" that is supported by a written report, taking into account certain standard valuation factors (asset

value, present value of future cash flow, market value of similar companies, and any other relevant factors). The company must not have a class of equity securities that is traded on an established securities market; it must have conducted a trade or business for less than 10 years; and the stock must not be subject to any put or call right or obligation of the company or another person to purchase the stock other than a typical right of first refusal or unvested-share repurchase right; the company must not reasonably anticipate that it will undergo a change in control or a public offering of its securities within 180 days following the relevant date to which the valuation applies; the valuation must be set forth in a written report, and persons performing the valuation must have "significant knowledge and experience or training in performing similar valuations."

According to the ISO rules, as long as a *good faith attempt* to set the exercise price of the option at (or greater than) the stock's grant-date fair market value was made, then the award will be treated as having been made at fair market value. For other options, market value must be determined by "reasonable application of a reasonable valuation method." It is unclear what practical difference there may be between a "good faith" and a "reasonable" valuation standard, but it is thought that the ISO "good faith" standard may be an easier standard to meet. In either event, some effort must still be made to ensure the options are set at fair market value, for purposes of avoiding the penalties of Section 409A. And because many options will be granted as ISOs but they may be subject to a subsequent disqualifying disposition (making them subject to treatment as NSOs), most companies will not want to rely solely on their good faith attempt to set exercise price.

Private companies frequently procure independent third-party valuations for purposes of establishing option strike price. This is often done in advance of closing a financing transaction, and it may be a requirement of third party investors.

Factors that go into the valuation are:

(1) Value of tangible and intangible assets;
(2) Present value of future cash flows;
(3) Market value of stock of similar companies;
(4) Discounts for lack of marketability (provided all available information on the company is taken into account);
(5) Whether the same valuation is used for other purposes that have an economic effect on the company, its stockholders and creditors.

PHANTOM STOCK PLANS & DEFERRED COMPENSATION PLANS

Is a true equity interest really necessary to incentivize an employee? Many controlling shareholders of closely-held companies appreciate that granting stock to employees, or granting employees the right to acquire stock via a stock option, will expand the number of shareholders and will create a larger class of minority owners to whom the majority will owe some duties. All shareholders have certain statutory information rights, minimal voting rights, and the rights to participate to at least a minimal extent in an annual shareholders meeting or actions taking in lieu of a meeting.

A phantom stock plan can be a useful alternative to an option plan. This allows the owners to reward employees with something that enables them to participate in the company's increase in value without diluting existing owners' ownership and without conferring shareholder-type rights on employees.

A phantom stock plan does not actually grant stock or a future right to stock. Instead, it grants the recipient (typically an employee) "units" of phantom stock; each unit is equal in value to an actual share of stock but does not confer upon the holder any of the benefits or rights of actual stock ownership. The units can be subject to vesting over time, like stock options.

The phantom stock plan typically provides that upon a designated trigger event, the company must obtain a valuation of the units and make a payout to the holder of the units. Typical trigger events would include a termination of employment (but not a termination for cause) or an acquisition of the company. The plan typically includes additional terms and conditions and mechanics for payment, such as detailed provisions governing valuations of units, timing of payouts, and vesting.

A phantom stock award is considered deferred compensation under the Internal Revenue Code, and, as such, it must comply with Rule 409A of the IRC. This means that there can be limits on the sizes and timing of grants under the phantom stock plan. Subject to compliance with 409A's limitations, awards are not taxable to the recipient when the award is made, but upon payout to the unit holder the payout is taxed as ordinary income.

BONUS COMPENSATION PLANS

The company might consider a form of cash bonus plan instead of an option or phantom stock plan. A cash bonus plan may be the easiest to implement. It would offer additional cash compensation to the employee contingent on the company achieving certain financial milestones, or contingent upon the employee achieving personal work milestones.

For example, the plan could provide that the employee receives an additional 5% of total annual compensation if the company's profits for the year exceed a designated threshold. Or the plan could provide that the employee receives an additional 5% for the prior year if the employee exceeded specific performance goals set for that employee.

There are many varieties of cash incentive compensation plans that employers use. The right form of plan and the right structure can vary greatly, depending on the particular goals and needs of the particular enterprise. See Part II of this series for more discussion about succession planning, and how owner-operators may consider transitioning stock ownership to a family group or class of employees earmarked to take over operations over time.

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