Equity-Related Compensation Plans

by
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I. Introduction

A. Overview

This outline covers the various methods and arrangements designed to compensate employees, in part, with stock or equity of the employer. Participation in these arrangements is typically limited to executives. The equity-related compensation methods described in this outline include incentive stock options, nonstatutory stock options, restricted stock, stock appreciation rights, phantom stock, performance share plans, book value stock, junior stock and convertible debentures.

B. Equity Compensation Generally

Stock of the employer is a popular medium of compensation for key employees of public corporations as well as privately or closely-held corporations. In large public corporations, stock compensation is a means of providing incentives to key employees to perform in a manner that will cause the value of the stock to increase. Stock compensation is often used to attract, retain and incentivise qualified key employees in lieu of substantial cash compensation in the following situations: 1) structuring start-up transactions, 2) structuring a growth-equity investment in an existing company, 3) structuring a buyout qualifying for recap accounting (before FAS 142), 4) structuring a turn-around investment in a troubled company, 5) compensating key employees in anticipation of an IPO or the sale of a venture capital financed company to a financial or strategic buyer, and 6) compensating key employees in a roll-up or the consolidation of a fragmented industry. In these situations, the key employee hopes to gain if the business succeeds and the company is sold or goes public.

Stock compensation is less popular in closely-held corporations where there is little chance of going public, and the stock has less value to the key employee unless there is a market in which to sell the stock or a buy-sell agreement requiring the purchase and sale of stock upon death, disability or termination of employment. Closely-held corporations still use stock ownership and equity-related compensation arrangements tied to the value of the company’s stock (e.g., stock appreciation rights, phantom stock and performance key employees’ plans) to compensate and motivate key employees.

C. Effect of Income Tax Rates on Equity Compensation

The Tax Reform Act of 1986 (‘TRA ‘86”) made certain fundamental changes in the tax treatment of various executive compensation arrangements. Prior to TRA ‘86, most stock compensation programs were structured to allow the executive to take advantage of
favorable capital gains treatment on the increase in value of the stock. To the extent the executive recognized capital gains, the employer would not be entitled to an offsetting compensation deduction. These programs also typically required a cash investment by the executive, often through the use of borrowed funds.

1. **Tax Rates**

Stock compensation programs had fewer tax advantages to executives after TRA ‘86 as a result of the reduction of individual rates (15%, 25% and 28%) below the top corporate rate (34%), and the limited advantage of capital gains treatment. However, for years beginning in 1993, the Revenue Reconciliation Act of 1993 ("RRA ‘93") resulted in substantial tax increases for the high income taxpayer (36% and 39.6%). The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the “2003 Jobs and Growth Act") reduced individual rates in excess of 15% for tax years beginning after December 31, 2002, to 25%, 28%, 33%, and 35%. The provision does not modify the application of the pre-2003 Jobs and Growth Act law sunset to the rate reductions contained in the Economic Growth and Tax Relief Reconciliation Act of 2001. The 2003 Jobs and Growth Act accelerates the increase in the taxable income levels of the 10% rate bracket, increasing the amount of taxable income from $6,000 to $7,000 for single individuals (from $12,000 to $14,000 for married filing jointly) effective for tax years beginning after December 31, 2002, and before January 1, 2005.

2. **Capital Gains Treatment**

TRA ‘86 repealed the prior deduction for net long term capital gains. Capital gains were then taxed at ordinary income rates up to a maximum tax rate of 28%. Consequently, many stock compensation programs which had the goal of converting compensation income into capital gains became less attractive after TRA ‘86. The top individual tax rate of 39.6% on ordinary income under RRA ‘93 made the ordinary income rate substantially greater than the 28% maximum capital gains rate, increasing the advantage of capital gains treatment for upper-income taxpayers. The 2003 Jobs and Growth Act reduced the 10% and 20% rates on net capital gains to 5% (zero, in 2008) and 15%, respectively. These lower rates apply to both the regular tax and the alternative minimum tax on assets held more than one year. The 2003 Jobs and Growth Act applies to sales and exchanges (and payments received) on or after May 6, 2003. The 2003 Jobs and Growth Act does not lower the 25% maximum rate imposed on unrecaptured section § 1250 gain or the 28% maximum rate on the sale of most collectibles and gain on the unexcluded part of § 1202 small business stock. Special rules apply to stock (and other capital assets) acquired after December 31, 2000 and held for more than 5 years. Section 1202.

3. **Interest Deductions**

Deductions for interest paid on indebtedness other than on certain
indebtedness secured by real estate were phased out under TRA ‘86. After 1990, no personal or consumer interest is deductible and investment interest deductions cannot exceed net investment income. Compensation programs which require a cash outlay from the executive, and hence the use of borrowed funds, are relatively less attractive than benefits which do not require such funds. Benefits which require a cash investment from the executive (e.g., stock options or restricted stock) are now frequently offered in tandem with arrangements that provide cash to the executive (e.g., cash bonuses or stock appreciation rights).

4. Alternative Minimum Tax

The alternative minimum tax rate was raised by TRA ‘86 from 20% to 21%, and further increased by RRA ’93 to 26% of the first $175,000 of alternative minimum taxable income (reduced by the applicable exemption amount), and 28% of alternative minimum taxable income (reduced by the applicable exemption amount) in excess of $175,000. The exemption amount for married taxpayers is phased out by 25% of the amount by which alternative minimum taxable income exceeds $150,000 ($112,500 in the case of unmarried individuals). The 2003 Jobs and Growth Act did not change the phase-out rules, but it did increase the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $58,000, and for unmarried taxpayers to $40,250 for tax years beginning in 2003 and 2004. The provision is effective for tax years beginning after December 31, 2002, and before January 1, 2005.

D. Choice of Entity Considerations

1. S Corporation Election

The S corporation election may be attractive for closely-held and start-up businesses desiring pass-through tax treatment to avoid the corporate level income tax. Final regulations under section 1361 and several private letter rulings permit S corporations to adopt a wide variety of equity based compensation methods. See Treas. Reg. §1.1361-1(b)(3) (restricted stock issued in connection with the performance of services and which is substantially nonvested is not treated as outstanding stock for purposes of subchapter S unless a section 83(b) election is made by the holder, in which case the restrictions are ignored in determining whether there are disproportionate rights to distributions). See Treas. Reg. §§1.1361-1(g)(4)(ii)(B)(2) and 1.1361-1(j)(4)(iii) (call options issued in connection with performance of services not treated as second class of stock (a) if the options are nontransferable (within the meaning of Treas. Reg. § 1.83-3(d)) and do not have a readily ascertainable fair market value (as defined in Treas. Reg. § 1.83-7(b)), or (b) unless the options are substantially certain to be exercised at a strike price substantially below the value of the underlying stock on the date the call option is issued). Equity-based arrangements (e.g., SARs and phantom stock units) may be issued with terms that will not cause them to be deemed a second class of stock.
under section 1361(b)(1)(D). Such an instrument is to be tested under the deferred compensation rules of Treas. Reg. § 1.1361-1(b)(4) whereby it is not deemed to be “stock” if it: (i) does not convey the right to vote; (ii) is an unfunded and unsecured promise to pay compensation in the future; (iii) is issued to an employee, or an individual who is an independent contractor, in connection with the performance of services for the corporation; and (iv) is issued under a plan with respect to which the employee or independent contractor is not taxed currently on income. See, e.g., PLR 9501032 (Oct. 5, 1994); PLR 9413023 (Dec. 23, 1993); PLR 9406017 (Nov. 15, 1993; and PLR 9406018 (Nov. 5, 1993). See, also, PLR 9308006 (restrictions on the transferability of S corporation stock in a buy-sell agreement, redemption plan, option plan, employment agreement and put-call arrangement did not create a separate class of stock); PLR 9308022 (grant of current and future share awards to officers and key employees did not violate separate class of stock requirement); PLR 9803023 (phantom stock is not a second class of stock for an S corporation).

2. Partnerships and Limited Liability Companies (LLCs)

Partnerships and LLCS are also attractive vehicles for closely-held and start-up businesses, achieving pass-through tax treatment without the restrictions and limitations of the S corporation. Generally, the grant of a profits interest to a partner (whether for the performance of services or other reasons) is not a taxable event to either the recipient partner or the partnership. Rev. Proc. 93-27, 1993-2 C.B. 343. This safe harbor is not available if: (i) the profits interest relates to a substantially certain and predictable stream of income from the partnership assets, such as income from high-quality debt securities or a high quality net lease; (ii) within two years of receipt, the recipient partner disposes of the profits interest; or (iii) the profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of section 7704(b). Id., at Section 4.02. See also, Campbell v. Commissioner, 943 F.2d 815 (8th Cir. 1991) (profits interest held to lack an ascertainable value at the time of receipt); and Diamond v. Commissioner, 56 T.C. 530 (1971), aff’d, 492 F.2d 286 (7th Cir. 1974) (a profits interest that appeared to be a disguised capital interest, sold for $40,000 within a few weeks of its receipt, was held to be taxable).

In PLR 9822012 (Feb. 5, 1998), the Service determined that a deduction is available to a partnership under section 404(a) for nonqualified stock options and SARs granted to the partnership’s employees by the corporate general partner of the partnership. An employee or independent contractor of the partnership, not a partner, compensated in whole or in part with respect to partnership profits, will be taxed under the principles of section 83. See, e.g., PLR 9533008 (May 9, 1995). Reg. § 1.83-6(d)(1); Prop. Regs. 1.83-6(d) and 1.1032-3 (September 22, 1998).

II. Restricted Stock and Section 83

A. In General

Section 83 governs the amount and timing of income recognition when property is
transferred in connection with the performance of services. Absent a section 83(b) election (discussed below) the employee is taxed on the excess of the value of the property received over the amount (if any) paid for the property at the earlier of the time the property becomes “transferrable” or is no longer subject to a “substantial risk of forfeiture.” The value of the property for this purpose is determined without regard to any restrictions other than restrictions which by their terms will never lapse.

B. Substantial Risk of Forfeiture

Property is subject to a substantial risk of forfeiture if the transferee’s rights to full enjoyment of the property are conditioned upon the performance of substantial services. A typical example of a substantial risk of forfeiture would be the sale of stock to an employee for a nominal price on the condition that the shares be returned to the employer for the same price in the event that the employee fails to remain in the employ of the employer for a specified period. Often the period of the restriction phases out over time. For example, the employee might become vested in 25% of the shares each year over a four-year period. In that case, the employee would (in the absence of a section 83(b) election), be taxed in each of the four years of vesting on the excess of the value of the vested shares on the respective dates of vesting over the amount paid. Property is “transferable” if the rights of a transferee of the property are not subject to a substantial risk of forfeiture.

Whether or not a substantial risk of forfeiture exists in a particular circumstance is a question of fact. Treas. Reg. §1.833(c)(1).

If the rights in the stock are conditioned, directly or indirectly, upon the future performance (or refraining from performing) substantial services, a substantial risk of forfeiture exists. Section 83(c)(1).

(a) Consulting Services. The requirement that a retiring employee provide consulting services to the employer does not constitute a substantial risk of forfeiture unless the executive is in fact expected to perform substantial services. Treas. Reg. §1.833(c)(2).

(b) Covenant Not to Compete. The requirement that a former employee refrain from competing with the employer may or may not constitute a substantial risk of forfeiture, depending on the facts and circumstances. Treas. Reg. §1.833(c)(2).

(c) Controlling Shareholder. A number of factors (listed in the regulations) are taken into account in determining whether the possibility of forfeiture is substantial in the case of an executive who owns a “significant amount” of the voting stock of a corporation or its parent corporation. Treas. Reg. §1.833(c)(3). What constitutes a “significant amount” is not clearly delineated.

ShortSwing Profits Rule. In the case of an executive subject to the shortswing