



# WRMarketplace

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## **TOPIC: Equity-Based Incentive Compensation: Actual vs. Synthetic Equity Part I – An Introduction**

**MARKET TREND:** The competition for executive talent remains high. Various approaches for tying executive compensation to a company's value can offer effective tools for both enhancing company performance and attracting and retaining talent. Companies, however, need to decide whether they want to use actual equity or "synthetic" equity arrangements to accomplish their goals as they differ in effect and implementation.

**SYNOPSIS:** Stock options and restricted stock have been common compensation tools for several decades and can be effective in attracting, retaining, and motivating employees to render the desired performance. These approaches, however, may have unexpected tax consequences for the employees and may cause the company to give up an unacceptable degree of control. Synthetic equity programs are more recent developments that can address many of the concerns presented by stock options and restricted stock.

**TAKE AWAYS:** Equity-based incentive compensation is important for companies and executives alike. This compensation can be provided through the delivery of actual equity, in the form of stock options or restricted stock, or through the use of synthetic equity arrangements. The keys to successful compensation planning using equity-based compensation are to understand the advantages and disadvantages of each approach and to choose the one that, on balance, will best accomplish the company's objectives.

It is widely recognized that paying "equity-based" compensation, which is tied to the value of the employer's equity, can provide a valuable incentive for improving the performance of employees (particularly among executives) and a meaningful reward for enhancing the employer's value. Often, this compensation is provided in the form of actual equity through arrangements like stock options and restricted stock. Alternatively, this compensation may be provided through a "phantom" or "synthetic" equity arrangement. This *WRMarketplace* provides an overview of the tax and practical considerations of each arrangement, while Part II of this series will take a closer look at the use of some of these approaches in practice.

## **STOCK OPTIONS**

**Overview.** A stock option is a contract allowing an individual to purchase stock of the issuing company during a specified period for a fixed exercise price. Upon payment of the exercise price, the participant becomes a shareholder in the issuing company. There are generally two types of option – "nonqualified stock options" ("NSOs") and "incentive stock options" ("ISOs").

**Tax Treatment.** In reviewing the tax treatment of stock options, there are two key actions that can trigger tax recognition: (1) the exercise of the option ("option exercise") and (2) the subsequent disposition of the stock received from the option exercise ("stock disposition").

**NSOs – Tax on Option Exercise.** With NSOs (typically the majority of stock options), the participant (optionee) generally recognizes **ordinary income as of the option exercise** in an amount equal to the excess of the fair market value ("FMV") of the stock at the date of option exercise over the exercise price paid for the stock. The exercise price must at least equal the stock's FMV on the date of the NSO's grant. The optionee and the issuing corporation also **may pay Social Security and Medicare taxes** based on the option exercise.

**ISOs – Tax on Stock Disposition.** With ISOs, however, the optionee recognizes **capital gain upon stock disposition** rather than ordinary income at option exercise,

assuming that the stock is held until the later of the second anniversary of the ISO's grant or the one-year anniversary of the option exercise. Social Security and Medicare taxes also are **not** payable upon the option exercise.

**Practical Result – Little Difference.** Although ISOs seem to offer more favorable tax treatment than NSOs, the practical result for the optionee is similar in both cases because of the alternative minimum tax (“AMT”). The difference between the stock's FMV at option exercise and the exercise price (which must at least equal the stock's FMV at the option grant) is an adjustment item in calculating the optionee's AMT liability for the year of exercise. Thus, both NSOs and ISO may create complicated tax situations for the optionee, unless the option exercise and stock disposition occur simultaneously or within a short period of each other. Otherwise, the optionee may owe income tax when he or she does not have the liquidity to pay that tax.

### Practical Considerations.

**Award Based on Company's Future Performance.** The employer should consider whether stock options will provide the desired incentive for the employee. Based on the tax rules noted above, stock options must be granted with an exercise price at least equal to the stock's FMV on the date of the option grant. Accordingly, stock options only provide economic value to the optionee if the company's value increases after option grant. While that may incentivize an employee's future actions, the employer also may want to award employee compensation based on the company's current value. As stock options only capture future appreciation, they don't address this goal.

**Employee Becomes Shareholder.** Employers also must recognize that the award of stock options allows the optionee to become a shareholder of the company – with all the attendant legal rights – upon option exercise. The existence of minority shareholders can prevent the original owners from conducting business without interference. For example, minority shareholders may have the right to examine the company's books and records. Perhaps more importantly, in the event of a sale of the company, potential buyers may not want to deal with minority shareholders (or even holders of outstanding options to acquire employer stock), since minority shareholders may be able to assert dissenter's rights under state law and hold up or derail a proposed transaction.

**Liquidity Needs.** In addition to any tax liability, the employee may need to have available cash to pay the exercise price upon option exercise.

## **RESTRICTED STOCK**

**Overview.** Restricted stock is typically an award of employer stock, subject to the requirement that the individual forfeit the shares back to the employer if the criteria established by the issuer are not satisfied. These “vesting” criteria typically obligate the employee to remain employed for a specified period but also may require the employee to achieve specified performance objectives to allow the stock to vest (i.e., remove the stock restrictions and forfeiture requirements).

**Tax Treatment.** For tax purposes, the key actions for restricted stock are the vesting of the stock in the employee (“**vesting date**”) and the award or grant of the restricted stock to the employee (“**grant date**”).

**Tax Based on Vesting Date.** Unless the employee has made an “83(b) election” as discussed below, upon vesting of the stock, the employee recognizes **ordinary taxable income on the stock’s FMV as of the vesting date**. Social Security and Medicare taxes are also owed based on the time of vesting. Thus, as with stock options, if the restricted stock vests at a time when there is no liquid market for the employer’s stock, the employee may have a tax liability without having sufficient cash available to pay that liability.

**Tax Based on Grant Date - 83(b) Election.** Alternatively, an employee can elect to be **taxed on the restricted stock’s FMV as of the grant date** by making what is referred to as an “83(b) election.” This election potentially enables the employee to pay less ordinary income tax by basing the tax on the presumably lower value of the stock as of the grant date rather than the vesting date. It also allows the employee to anticipate more accurately the liquidity needs generated by the tax liability. The employee, however, **cannot recover the taxes paid if the restricted stock decreases in value after the grant** and may not be able to recover the taxes if the stock is forfeited back to the employer before it vests.

**Practical Considerations.** Unlike stock options, restricted stock awards can compensate an employee based on the then-full value of the company and do not require the employee to come up with cash to acquire the stock. But restricted stock creates the same issues as stock options in terms of giving the employee full rights as a shareholder of the employer – in this case from the time of the grant date of the restricted stock award, even if the stock is not vested.

## “Phantom” or “Synthetic” Equity

**Overview.** Unlike stock options or restricted stock plans, phantom or synthetic equity plans do not promise to deliver shares of the employer. Instead, they promise a payment in cash based on the value of the employer’s shares at the time of payment (though plans can be structured to allow payment in shares if that medium of payment is desirable at the time of payment). The value to be paid with respect to a synthetic equity award can be based on the full value of a share or the appreciation in the value of a share since the time of award.

**Tax Treatment.** A participant in a synthetic equity plan is not taxed until he or she actually receives payment. In all cases, the **tax payable will be at ordinary income rates**; there is no way of obtaining capital gains tax treatment for a synthetic equity award. Generally, a synthetic equity plan is structured to pay out on a liquidity event and often pays out in cash. As a result, the potential exposure to tax liability when there is no cash available to pay the tax does not exist. In addition, the employer is similarly not obligated to make a payment when it cannot afford to do so.

**Practical Considerations.** In recent years, the use of synthetic equity plans has increased in frequency because they generally provide solutions to the problems described above with respect to stock options or restricted stock. Because these synthetic plans are not stock options, the tax laws governing the determination of FMV do not apply, giving synthetic plans greater flexibility in establishing the amount that will be paid to the employee and less administrative cost and burden than option plans. Also, because the synthetic equity plan generally does not grant shares of stock to employees, the plan participants do not acquire potential troubling or burdensome shareholder rights.

Although synthetic equity plans address many of the concerns presented by stock options and restricted stock, they are not without their own issues. For example, the motivational value of the award may be diminished if an employee wants actual equity in the employer. But more importantly, a synthetic equity plan may be a “deferred compensation plan” subject to the requirements and restrictions of IRC §409A, which imposes strict limitations on the operation of a deferred compensation plan, severely limits the ability to change provisions relating to payments under such a plan, requires the specification of payment provisions at the time the award of deferred compensation is made, and subjects an employee to current taxation with interest plus a 20% tax penalty if the requirements of IRC §409A are violated (see *WRMarketplace No. 13-45 and No. 15-21* for a more detailed discussion of IRC §409A). Accordingly, careful consideration of the terms and conditions of these arrangements must be

undertaken before they can be implemented. Part II of this series will describe in more detail the planning issues involved in setting up a synthetic equity program.

### **COMPARING EQUITY-BASED COMPENSATION PROGRAMS – A SUMMARY**

<b>PROGRAM</b>	<b>ADVANTAGES</b>	<b>DISADVANTAGES</b>
<b>NSOs</b>	<ul style="list-style-type: none"> <li>• Provides compensation based on increase in employer’s future value</li> <li>• Requires employee to have “skin in the game” by paying a portion of the value of the stock</li> <li>• Affords employee the opportunity to receive capital gains tax treatment on post-exercise stock appreciation</li> <li>• Allows employee to acquire actual equity in employer</li> </ul>	<ul style="list-style-type: none"> <li>• Does not compensate employee based on existing value of employer</li> <li>• May require employee to have cash available to pay exercise price</li> <li>• Can subject employee to tax liability when no liquidity to pay it</li> <li>• Requires potentially costly process to determine stock FMV as of grant date</li> <li>• Gives executive legal rights as a shareholder of employer with ability to interfere with original owners’ management or sale of company</li> </ul>
<b>ISOs</b>	<ul style="list-style-type: none"> <li>• Same as with NSO</li> <li>• No income tax on option exercise (capital gains tax on stock disposition)</li> <li>• No Social Security and Medicare taxes</li> </ul>	<ul style="list-style-type: none"> <li>• Same as with NSO</li> <li>• Requires employee to hold stock for significant period to obtain capital gains tax treatment</li> </ul>
<b>Restricted Stock</b>	<ul style="list-style-type: none"> <li>• Provides compensation based on full value of employer</li> <li>• Does not require employee to come up with cash to acquire stock</li> </ul>	<ul style="list-style-type: none"> <li>• Does not tie compensation solely to value created after the grant</li> <li>• Can subject employee to tax liability at a time when no</li> </ul>

PROGRAM	ADVANTAGES	DISADVANTAGES
	<ul style="list-style-type: none"> <li>• Affords employee the opportunity to receive capital gains tax treatment on post-vesting stock appreciation</li> <li>• Allows employee to limit tax liability at vesting by making 83(b) election</li> <li>• Allows employee to acquire actual equity in employer</li> </ul>	<ul style="list-style-type: none"> <li>• liquidity to pay it</li> <li>• Gives employee legal rights as a shareholder of employer with ability to interfere with original owners' management or sale of company</li> </ul>
<b>Synthetic Equity</b>	<ul style="list-style-type: none"> <li>• Gives employer flexibility to determine how value of company is calculated</li> <li>• Ties taxation to availability of liquidity</li> <li>• Does not give employee rights of minority shareholder in employer</li> </ul>	<ul style="list-style-type: none"> <li>• Motivational value of award may be diminished if employee wants actual equity in employer</li> <li>• Provides no opportunity for capital gains tax treatment</li> <li>• May be a deferred compensation plan under IRC §409A, limiting employer's ability to modify payment provisions after award is made</li> </ul>

### **TAKE-AWAYS**

Equity-based incentive compensation is important for companies and executives alike. This compensation can be provided through the delivery of actual equity, in the form of stock options or restricted stock, or through the use of synthetic equity arrangements. The keys to successful compensation planning using equity-based compensation are to understand the advantages and disadvantages of each approach and to choose the one that, on balance, will best accomplishes the company's objectives.

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WRM #16-41 was written by Greenberg Traurig, LLP

Jonathon M. Forster

Martin Kalb

Richard A. Sirius

Steven B. Lapidus

Rebecca Manicone

Counsel Emeritus

Gerald H. Sherman 1932-2012

*Stuart Lewis 1945-2012*