

COMPENSATING KEY EMPLOYEES WITH STOCK OPTIONS AND DEFERRED COMPENSATION PLANS

In a recent article, we discussed compensating key employees with stock in your company. However, it is not always appropriate or desirable to have additional stockholders, and so in this article we will discuss some of the alternatives to issuing stock.

Issuing Stock Options. A stock option gives an employee the right to acquire company stock at an agreed-upon price (the "strike price") for a certain period of time. The receipt of a stock option of a closely held company by an employee as compensation for services *is not* taxable to the employee. A stock option in a closely held company can be useful because it allows the employee to acquire the stock, and pay any associated tax liability, at the option of the employee at such times as the plan allows. For example, the Stock Option Plan could provide that an employee can exercise the stock only upon the employee's retirement, or only if the company is sold.

In the case of a non-qualified option, the employee will recognize ordinary income *upon the exercise of the option* in an amount equal to the excess of the fair market value of the stock over the strike price. This same amount is also fully deductible by the company as an ordinary business expense in the year in which the employee exercises the option. The company is free to grant non-qualified options for any period of time and at any strike price.

Because the exercise of a non-qualified stock option is a taxable event for the employee, non-qualified options work well where the employee will exercise the option in connection with the sale of the company. The employee can exercise the option, acquire the stock, and then receive a pro rata share of the net proceeds from the sale of the company. If, on the other hand, a non-qualified stock option plan allows the employee to exercise the option upon his or her retirement, the plan should also provide that the company will redeem the stock acquired by the employee at the same time. The plan should also provide a method for valuing the employee's stock, as well as for paying this amount to the employee over time. By doing this, the employee gets a stream of income over time, and the company does not have a former employee as a minority stockholder.

In the case of a qualified option, the employee will recognize income only *upon the sale of the stock* which was acquired by the exercise of the option. Unless the employee was in an alternative minimum tax situation, the income in this case would be equal to the excess of the net proceeds from the sale of the stock over the strike price, and provided that the employee held the option for more than one year before exercising it, this income would constitute long-term capital gain. Unlike non-qualified options, however, qualified options must meet the requirements of the tax code. For example, a qualified option may not have a term of more than ten years and may not be issued with a strike price which is less than the fair market value of the stock (or in some cases 110% of the fair market value of the stock) at the time the option is issued. In addition, the company is never entitled to a deduction in connection with the grant or exercise of qualified options.

Unlike the employee who is issued actual stock in the company, an employee who owns stock options will not have any of the rights of a stockholder in the company unless and until he or she exercises the option and acquires the stock. Under each state's corporate law, a stockholder in a closely held corporation has certain statutory rights and is owed certain fiduciary duties by the officers, directors, and other stockholders of the company which can complicate both corporate governance and the ability of the majority owners to engage in certain types of transactions to the detriment of the minority stockholders. All of these issues can be appropriately avoided by the use of either qualified or non-qualified stock options.

Using a Stock Appreciation Rights Plan. A Stock Appreciation Rights Plan is simply a form of deferred compensation which bases the amount of the deferred compensation on the appreciation in the value of the company's stock. Such plans are designed to give employees some of the economic benefits associated with stock ownership without creating any adverse tax consequences associated with the receipt of actual stock as compensation for services. A Stock Appreciation Rights Plan benefits the company because it does not create any of the governance or fiduciary issues which arise if the employees receive actual stock. In addition, amounts paid to the employee under the plan are fully deductible by the company as an ordinary business expense in the year(s) in which they are made.

With a Stock Appreciation Rights Plan, the employee does not acquire actual stock in the company, nor even the right to acquire stock in the company. Instead, the employee is granted stock appreciation rights having a value which is tied to the value of the company's common stock. In a typical Stock Appreciation Rights Plan, the employee will be granted stock appreciation rights having an initial value equal to the fair market value of the company's common stock as of the date such rights are granted. These rights will then be valued again upon the happening of certain future events (for example, the sale of the company or the retirement of the employee), and the employee will be entitled to receive deferred compensation equal to the appreciation in value of the rights which he or she was granted.

Basing deferred compensation on stock appreciation is just one of the ways that deferred compensation can be measured. Deferred compensation plans can also provide employees with deferred compensation based on other measures of financial performance, either for the company as a whole or for the particular employee.

The Employee as Creditor. Stock Appreciation Rights Plans and other non-qualified deferred compensation plans are "unfunded" plans, and the employee is like any other unsecured creditor of the company. Despite being "unfunded," companies can and often do set aside funds each year for the purpose of meeting its deferred compensation obligations in the future. These funds can be commingled with other company funds, held in a separate bank account, or held in a so-called "rabbi trust." While plans which set aside funds in a separate account or rabbi trust offer the employee some assurance of payment, these plans are nevertheless "unfunded" because the funds set aside are still subject to the claims of the company's creditors. Thus, the employee has no assurance of payment in the event of the company's bankruptcy or insolvency. A plan

which puts the plan assets beyond the reach of the company's creditors may be subject to ERISA. This adds costs, complexities, and limitations which may be unacceptable to both the company and the employee.