

COMPENSATING KEY EMPLOYEES WITH STOCK

For the owner of a closely-held business like a rep firm, it seems only natural to seek to retain key employees by offering them some stock in the company. Not only does it offer the employee some “pride of ownership,” but it also provides the current owners with a group of potential buyers for their stock when it’s finally time to retire. But as with most things in life, there are some downsides as well. It is not an entirely win-win situation.

There are several ways to provide key employees with stock. The company can either sell stock to employees, or issue stock to employees as compensation for services. In addition, the current stockholders can sell a portion of their stock to keys employees.

Sale of Stock by the Corporation This is very straight-forward, but probably not very appealing to many employees, since it requires that they pay for the stock. The amount received by the company from the sale of its stock is a capital contribution rather than income to the company. A purchase of stock by an employee will not result in income to the employee except in the case of a bargain sale, i.e., where the purchase price is less than the fair market value of the stock. In the case of a bargain sale, the employee will realize ordinary income equal to the excess of the fair market value of the stock over the price he or she paid for the stock.

Issuing of Stock by the Corporation as Compensation for Services Stock issued as compensation for services represents ordinary income to the employee in an amount equal to the fair market value of the stock. This same amount is also fully deductible by the company as an ordinary business expense for the same year in which the employee takes the value of the stock into income. From the employee’s point of view, paying tax on the fair market value of the stock is preferable to paying the company for the entire fair market value of the stock. As a practical matter, the company may have to give the employee a cash bonus so that the employee can pay the tax liability on the receipt of the stock.

When stock is issued as compensation for services, the employee can defer taking the value of the stock into income in the year in which the stock is received if the stock is subject to a substantial risk of forfeiture, as, for example, where the employee’s right to the stock is conditioned on the employee’s continued employment for some period of time. Once the employee becomes fully vested in the stock, however, he or she must take its then fair market value into income. Hence, postponing the taxable event can result in an increased tax liability for the employee because the stock has appreciated in value.

Sale of Stock by Existing Stockholders Like the sale of stock by the company to the employee, this requires that the employee pay for the stock. From the selling stockholder’s point of view, the amount received from the sale of the stock over the stockholder’s adjusted basis in the stock will be taxed as capital gain. Again, where the purchase price is less than the fair market value of the stock, the employee will realize ordinary income equal to the excess of the fair market value of the stock over the price he or she paid for the stock.

Gift of Stock by Existing Stockholders Whether a stockholder can make a gift of stock to a key employee will depend upon the relationship between the person making and the person receiving such a gift. If the key employee receiving the gift is a family member such as a spouse, child, grandchild, spouse of a child or grandchild, or a niece or nephew, the gift will undoubtedly be respected as such for tax purposes, and will not be deemed to be income to the recipient. If, however, the key employee is really just a key employee, then no matter that you “treat him like a son,” the “gift” will be treated as compensation for services.

Gift of Stock by the Company There is no such thing. The company can give a key employee a nice plaque or a gold watch, but a “gift” of stock will *always* be deemed to be income to the recipient.

Employees’ Rights as Stockholders An employee who owns stock in the company will have all of the rights which accrue to a stockholder, including the right to vote (if the stock is voting stock), and the right to examine the books and records of the company. In addition, the majority stockholders in the company owe a fiduciary duty to its minority stockholders. This results in a level of accountability to employee-stockholders that neither the company nor its majority stockholders had prior to the employees’ receipt of stock.

“Pride of Ownership” Although the positive effect of stock ownership is undeniable, its benefits to the employee are largely psychological rather than legal or economic. Ownership of a small percentage of the issued and outstanding shares of a closely held corporation will not give the employee, as a legal matter, any increase in compensation or any meaningful voice in the management of the company.

The stock will have economic value, however, if the company is sold. In the case of a rep firm, the buyer of the company will most likely be its key employees. For the key employees, then, eventually owning the company means that they need only to buy the stock (or have the company redeem the stock) of the company’s other stockholders.

Stockholders’ Agreements Any time a company has more than one stockholder, a Stockholders’ Agreement should be entered into among the company and all of its stockholders which:

- Restricts a stockholders right to sell his or her stock to a third party;
- Provides that the company and/or the other stockholders will purchase the stock of any stockholder:
 - who dies or becomes permanently disabled;
 - whose employment is either voluntarily or involuntarily terminated;

- who retires; or
- who files for bankruptcy or gets divorced.

The Stockholders' Agreement should carefully define the foregoing events and set forth the price (or formula for determining the price) and the payment terms applicable to each such event. The Stockholders' Agreement may also include a restriction on competition, prohibiting stockholders whose shares are being acquired by the rep organization from representing the organization's principal, calling on customers, or hiring employees.

Alternatives to Stock Ownership Despite the strong desire that owners often have to put actual stock into the hands of their key employees, there are alternatives such as stock options, stock appreciation rights plans, phantom stock plans, and other deferred compensation plans. These alternatives can be used to avoid some of the downsides to actual stock ownership which we have discussed. Once again, however, it is not a perfect world, and all of these alternatives lack one thing — they are not *actual* stock. For all of its complications, sometimes there is just no substitute for the real thing.