INCENTIVE COMPENSATION ARRANGEMENTS TO ATTRACT, MOTIVATE AND RETAIN KEY EMPLOYEES

I. PERFORMANCE-BASED COMPENSATION.

A. Commissions. Commissions are a form of compensation paid to an employee that is equal to a percentage of the sales price of the goods or services that the employee sells to customers.

1. For example, a stock broker may receive a commission equal to a percentage of each security the broker sells to customers.

2. Commissions may be the sole form of compensation paid to an employee. Alternatively, commissions may supplement a base salary and/or other compensation paid to an employee.

3. Commissions are taxed as ordinary compensation income to the employee and subject to withholding and FICA taxes.

4. The employer receives a compensation deduction equal to the commissions paid to the employee.

B. Production Pay. Production pay is a form of compensation based on the production of the employee.

1. For example, a dentist may be paid a certain sum for each exam he performs on a patient.

2. The employee is paid a certain amount of compensation for each task completed by the employee.

3. Production pay is taxed as ordinary compensation income to the employee and subject to withholding and FICA taxes.

4. The employer receives a compensation deduction equal to the amount of production pay received by the employee.

C. Merit Pay. Merit pay is a form of compensation paid to an employee based on the performance or achievement of the employee during a specified period of time.

1. Merit pay may be discretionary or based on performance metrics.

2. Merit pay is taxed as ordinary compensation income to the employee and subject to withholding and FICA taxes.

3. The employer receives a compensation deduction equal to the amount of merit pay received by the employee.

II. EQUITY-BASED COMPENSATION.

A. Corporations:

1. Stock. Stock of a corporation may be issued to an employee as additional compensation either at a discount or for no consideration.

a) The fair market value ("FMV") of the stock, less any amount paid for the stock, is taxed as ordinary compensation income to the employee. The employer corporation receives a compensation deduction equal to the amount taxed as compensation income to the employee.

b) Any appreciation in the stock after the date of grant is taxed as capital gain to the employee when he sells the stock. The employer corporation does not receive a deduction for any amount taxed as capital gain to the employee.

2. Stock Options. A stock option is a contractual right that gives the employee the right to purchase, for an indefinite or specified period of time, up to a certain number of shares of stock of the employer corporation for a specified exercise price. An employer corporation may grant incentive stock options or nonqualified stock options to an employee.

a) Incentive Stock Options ("ISOs"). ISOs are stock options that enjoy special tax treatment under the federal income tax laws.

(1) The employee receives actual shares of stock upon exercise of the ISOs.

(2) The employee does not recognize income at the time he exercises the option. Rather, the employee

recognizes income when he sells the underlying stock.

(3) The income on the employee's sale of the stock is taxed as capital gain if the employee held the stock for at least 2 years from the date the ISOs were granted and at least 1 year from the date the ISOs were exercised. The employer corporation does not receive a deduction for the ISOs granted to the employee or for the issuance of the underlying stock to the employee pursuant to the exercise of the ISOs.

(4) The employee is not subject to FICA taxes with respect to the capital gain on the sale of the underlying stock.

(5) The following requirements must be satisfied for stock options granted by an employer corporation to be considered ISOs:

    (a) The options must be granted to employees. Non-employee directors and contractors are ineligible.

    (b) The plan pursuant to which the options are granted must be approved by the shareholders of the corporation within 12 months before or after the plan is adopted.

    (c) The options must be granted within 10 years of the earlier of the adoption of the plan or the approval of the plan by the shareholders.

    (d) The options must be exercisable within 10 years of the date of grant.

    (e) The exercise price must equal or exceed the FMV of the underlying stock on the date of grant. If the employee already owns more than 10% of the outstanding stock (measured by voting power), the exercise price must be at least 110% of the FMV of the underlying stock on the date of grant and the options must be exercisable within a 5-year period beginning on the date of grant.

(6) For shares with respect to which ISOs become exercisable for the first time in any year, the special

tax treatment described above is unavailable to the extent the FMV of the shares exceeds $100,000.

b) <u>Nonqualified Stock Options ("NSOs")</u>. A nonqualified stock option is a stock option other than an ISO.

(1) The employee receives actual shares of stock upon exercise of the NSOs.

(2) NSOs can have a vesting period during which the employee must remain employed by the employer corporation before the employee is eligible to exercise the NSOs. All or a specified portion of the NSOs may vest on a date certain or upon the occurrence of one or more specified events. Alternatively, the NSOs may vest ratably over a specified period of time.

(3) The exercise price for a NSO is generally set at the FMV of the stock on the date of grant.

(4) The grant of a NSO is nontaxable to the employee.

(5) The employee realizes ordinary compensation income on the date he exercises the NSOs in an amount equal to the FMV of the stock less the exercise price (plus the amount, if any, paid for the NSOs by the employee). The employer corporation receives a deduction equal to the amount taxed to the employee as compensation income.

(6) Any appreciation in the stock after the date of grant is taxed as capital gain on the date the stock is sold by the employee. The employer corporation receives no deduction for any amount taxed as capital gain to the employee.

(7) A NSO may allow for a cashless exercise where the employee exercises the NSO without using cash to pay the exercise price. The holder effectively surrenders a number of shares of the underlying stock equal in value to the exercise price.

(8) The NSOs may terminate on the earlier of (1) some period of time after the date of grant (e.g., 10 years), or (2) within a certain period of time (e.g., 60 days) following termination of employment.

(9) Until the NSOs are exercised by the employee, he merely holds a contractual right to purchase the stock and has no rights of a shareholder to vote on corporate matters, receive dividends, or receive information regarding the corporation.

3. Restricted Stock. Restricted stock is stock that is granted to an employee subject to various restrictions such as vesting and forfeiture.

a) The employee generally forfeits the stock if he fails to satisfy certain vesting requirements relating to his service with the employer corporation or upon other events such as the employee's termination for cause. There are also limitations on the sale or other transfer of the stock to third parties.

b) The stock certificates are held in escrow until the shares vest.

c) The employee is considered a shareholder from and after the date of vesting with all the rights of a shareholder.

d) Restricted stock requires no outlay of cash by the employee to become a shareholder.

e) An employer corporation's grant of restricted stock generally is not considered deferred compensation subject to the rules of Section 409A of the Internal Revenue Code (the "Code").

f) The employee generally realizes ordinary compensation income equal to the FMV of the stock on the date the shares become "substantially vested" (i.e., the stock is either transferable or is no longer subject to a substantial risk of forfeiture). Alternatively, the employee can make a so-called "Section 83(b) election" to have the FMV of the stock on the date of grant (less any amount paid) included in taxable income on the date of grant. If the employee makes a Section 83(b) election, any appreciation in the value of the stock after the date of grant is taxed as capital gain.

g) The employer corporation receives a compensation deduction at the time the employee recognizes compensation income. The deduction is equal to the amount of compensation income to the employee. The employer corporation does not receive a deduction for any amount taxed as capital gain to the employee.

4. Phantom Stock. Phantom stock is a promise from the employer corporation to make a cash payment to the employee based on the FMV of the corporation's stock.

   a) Phantom stock is merely a contractual right to receive a cash payment from the employer corporation measured by the FMV of the corporation's stock.

   b) Phantom stock is settled in cash. The employee does not receive any actual stock in the employer corporation. The employee has no voting or other rights associated with being a shareholder.

   c) The employee generally is taxed only as and when he receives payments with respect to the phantom stock. The entire amount received by the employee is taxed as ordinary compensation income. The corporation receives a compensation deduction equal to the amount recognized by the employee as compensation income.

   d) No portion of the payments with respect to the phantom stock is taxed as capital gain to the employee.

   e) The timing of payments with respect to phantom stock is subject to the rules of Code Section 409A.

5. Stock Appreciation Rights ("SARs"). An SAR is a promise from the employer corporation to make a payment of cash to the employee, upon the occurrence of one or more specified events, equal to the appreciation in the FMV of the corporation's stock in excess of a specified exercise price.

   a) An SAR is the equivalent of a stock option that is settled in cash upon exercise.

   b) The exercise price is typically equal to the FMV of the stock on the date of grant.

   c) The employee is generally taxed only as and when he receives payments with respect to the SAR. The entire amount received by the employee is taxed as ordinary compensation income. The corporation receives a compensation deduction equal to the amount recognized by the employee as compensation income.

d) No portion of the payments with respect to an SAR is taxed as capital gain to the employee.

e) The timing of payments with respect to SARs is subject to the rules of Code Section 409A.

6. Restricted Stock Units ("RSUs"). An RSU is a promise by the employer corporation to issue stock to the employee on the date of vesting of the RSU.

a) Unlike restricted stock, there is no transfer of shares to the employee until the RSUs vest.

b) RSUs eliminate the administrative burden of the employer corporation having to hold actual shares of stock in escrow.

c) No Section 83(b) election is available with respect to RSUs.

d) A grantee of RSUs is not entitled to vote as a shareholder or receive dividends.

e) The employee recognizes ordinary compensation income equal to the FMV of the stock. Any appreciation in the stock after the exercise of the RSUs is taxed as capital gain to the employee. The employer corporation receives a deduction equal to the amount of compensation income recognized by the employee.

f) The timing of payments with respect to RSUs may be subject to the rules of Code Section 409A.

B. Partnerships/LLCs:

1. Profits Interests. A profits interest is an equity interest in a partnership/LLC that gives an employee a share of the future profits and equity appreciation in the company.

a) A profits interest does not give the employee a share of the existing value of the partnership/LLC.

b) The receipt of a profits interest in a partnership/LLC is nontaxable to the employee unless: (i) the profits interest relates to a substantially certain and predictable stream of income from partnership/LLC assets (such as income from a high-quality debt security or a high-quality net lease); (ii) the employee disposes of the interest within two years of receipt; or (iii) the profits interest is a limited interest in a "publicly traded partnership."

c) A partnership/LLC does not receive a deduction with respect to the grant of a profits interest to an employee.

d) The employee becomes a "partner" for federal income tax purposes. The employee's share of partnership/LLC income is reported on a Schedule K-1 issued to the employee.

e) The employee no longer receives a Form W-2 with respect to his salary. Rather, the employee's salary is reported as a "guaranteed payment" on the Schedule K-1.

2. Capital Interests. A capital interest is an equity interest in a partnership/LLC that gives the employee, in addition to a share of future profits and equity appreciation in the company, a share of the existing value of the company.

   a) An employee recognizes ordinary compensation income on the receipt of a capital interest equal to the FMV of the interest.

   b) The partnership/LLC receives a deduction equal to the amount taxed as ordinary compensation income to the employee.

3. Equity Options. An equity option is an option that gives the employee the right to purchase, for an indefinite or specified period of time, a certain number of units in the company at a specified exercise price.

   a) The grant or vesting of an equity option is nontaxable to the employee.

   b) The employee recognizes ordinary compensation income on the exercise of the equity option (if the equity interest received is substantially vested) equal to the amount by which the value of the underlying equity interest exceeds the exercise price.

   c) The partnership/LLC receives a deduction in an amount equal to the compensation income recognized by the employee.

   d) Upon exercise of the equity option, the employee becomes an equity owner with a capital account equal to the FMV of the underlying equity interest taken into account in determining the employee's compensation income.

e) The employee is allocated a distributive share of the partnership/LLC's income and begins to receive Schedules K-1 from the company.

4. Restricted Equity Interests.

a) Profits Interests. An employee who is granted a restricted (unvested) profits interest is treated as receiving the interest (and, thus, treated as a "partner") on the date of grant.

(1) The following requirements must be satisfied:

(a) Both the partnership/LLC and the employee treat the employee as a "partner" in the partnership/LLC from the date the interest is granted;

(b) The employee takes into account the distributive share of partnership/LLC income, gain, loss, deduction, and credit with respect to the interest in determining his tax liability for the entire period during which the employee holds the interest;

(c) Neither the partnership/LLC nor the other partners/members take a compensation deduction in connection with the grant of the interest; and

(d) The other requirements applicable to an unrestricted profits interest discussed above are satisfied.

(2) The employee is not required to make a Section 83(b) election for a restricted (unvested) profits interest (although the employee might consider making a protective Section 83(b) election in case the interest is sold within two years).

b) Capital Interests. A capital interest in a partnership/LLC is restricted (unvested) if the interest is nontransferable or subject to a substantial risk of forfeiture.

(1) A capital interest is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the interest is conditioned upon the future performance of substantial services by the employee.

(2) An employee receiving a restricted capital interest generally is not taxed on the grant of the interest until the restriction lapses.

(3) An employee receiving a capital interest may accelerate the date upon which the interest is taxed by making a Section 83(b) election no later than 30 days after the grant of the interest. The Section 83(b) election allows the recipient to treat the grant of the interest as an immediate taxable event notwithstanding the fact that the interest has not yet vested.

(4) If the employee makes a Section 83(b) election, the employee recognizes, as ordinary compensation income, an amount equal to the FMV of the capital interest (less the amount, if any, that the employee pays for the interest). Any subsequent appreciation in the capital interest is generally taxed at capital gains rates upon the disposition of the interest.

(5) If the employee does not make a Section 83(b) election, he does not recognize income until the capital interest vests and, at such time, the employee recognizes ordinary compensation income to the extent of the then FMV of the portion of the capital interest that has vested (less the amount, if any, that the recipient paid for the interest).

5. Phantom Equity. A partnership/LLC can grant an employee a phantom equity unit that represents a contractual right to receive a cash payment equal to the FMV of a unit of partnership/LLC equity interest upon the occurrence of one or more specific events.

a) The employee's status as an employee does not change for tax purposes. The employee continues to be issued a Form W-2 for wages, bonuses, and other compensation and benefits.

b) The employee is generally taxed only as and when he receives payments with respect to the phantom equity. The entire amount received by the employee is taxed as ordinary compensation income. No portion of the amount received by the employee is taxed as capital gain. The partnership/LLC receives a compensation deduction at the time the employee recognizes compensation income.

c) The timing of payments with respect to phantom equity is subject to the rules of Code Section 409A.

6. Equity Appreciation Rights. An equity appreciation right is a contractual right to receive, upon the occurrence of one or more specified events, a cash payment from the partnership/LLC equal to the appreciation in the value of the underlying equity in the company.

a) The employee is generally taxed only as and when he receives payments with respect to the equity appreciation rights. The entire amount received by the employee is taxed as ordinary compensation income.

b) The corporation receives a compensation deduction at the time the employee recognizes compensation income. No portion of the payments with respect to the equity appreciation right is taxed as capital gain to the employee.

c) The timing of payments with respect to equity appreciation rights is subject to the rules of Code Section 409A.

III. DEFERRED COMPENSATION.

A. Elective Deferral Arrangements. An elective deferral arrangement allows the employee to defer all or a portion of his compensation to a future date.

1. The amounts deferred by the employee may be limited to the employee's base salary or include incentive compensation.

2. The deferred amounts are credited by the employer to an account for the employee. The deferred amounts are subject to the claims of the employer's creditors.

3. Any earnings on the deferred amounts accumulate on a tax-deferred basis.

4. The employee generally is permitted to elect the time at which the deferred amounts are distributed subject to the limitations of Code Section 409A.

B. Excess Benefit Plans. An excess benefit plan is a plan maintained by the employer for the sole purpose of providing benefits for certain employees in excess of the limitations on contributions and benefits on qualified benefit plans.

1. An excess benefit plan may be a separate part of a qualified plan that provides other benefits.

2. The plan may be funded or unfunded by the employer.

3. An excess benefit plan does not have to be limited to highly compensated employees.

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