Go for the Gold: Attracting And Retaining Key Executives With Incentive Compensation

by Kenneth A. Goldstein, Esq.*

As companies vie for executives with track records or proven success, executive compensation plans can make the difference to the closely held businesses in attracting and retaining the key personnel required to enhance the value of the entity.

Incentive plans are one part of an overall compensation package that, if properly structured, will provide the financial incentives necessary to attract and retain highly qualified key personnel. Incentive plans can also preserve current working capital by shifting the payment of a portion of an executive’s overall compensation into the future.

The article explores incentive compensation plans for key executives of partnerships and limited liability companies (“LLCs”).

AVAILABLE ALTERNATIVES

Executive incentive plans can generally be classified according to the rights granted to the executive by the plan. On one end of the spectrum are plans that give the executive an actual equity stake in the company, such as equity bonus plans and equity purchase plans. Second on the spectrum are option plans that do not directly provide the executive an equity interest but give the executive the right to acquire an equity interest in the company. Next are plans that give rise to cash payments usually based on appreciation in the company’s value, but do not provide the executive actual equity ownership. These plans include phantom ownership plans and appreciation rights plans. Finally, there are plans such as performance unit plans, which not only do not provide any actual equity ownership, but which also base the benefits on variables other than the value of the company.

The principal distinction between the various plans relates to the benefits and burdens that accompany actual ownership. Plans that result in actual or potential equity ownership give the executive, upon becoming an equity owner, certain benefits, including the right to receive notice of meetings; inspect the books and records; hold the company, the controlling parties, or the equity owners accountable for fiduciary duties; and possibly voting rights. On the other hand, plans that do not provide actual or potential ownership are only contractual obligations which, while subject to the implied covenants of good faith and fair dealing, do not subject the company or the owners to any of the above obligations.

DECISION FACTORS

The principal issues for the company in connection with incentive plans concern the income tax treatment of the different plans and the psychological perception of “true ownership” versus a participation right in the company’s economic well-being. The company’s choice will be based on several factors, such as ownership structure, business strategy, and the role of outside personnel in expanding and managing the business. Another major consideration is whether the owners are willing to part with actual equity ownership, which may, as discussed above, give the executive certain rights. In general, closely held businesses prefer not to give actual equity ownership to executives. Unless the benefits are provided pursuant to a broad-based plan for many executives, true equity will motivate the executives better than economic equity, but the tax benefits to the executive of equity-based plans are superior to the tax consequences of non-equity based plans.

EQUITY BONUS PLANS

An equity bonus plan involves the outright grant of an equity interest to the executive. This is the simplest type of plan and usually involves no cash outlay by the executive.

Tax Consequences

The tax consequences differ depending on whether the equity interest in a partnership or an LLC received by the executive is a capital interest or a profits interest. Neither the Internal Revenue Code of 1986, as amended (“Code”) nor the regulations thereunder contain a consistent definition of the meaning of a profits interest in a partnership or LLC. However, Regs. §1.721-1(b)(1), Regs. §1.704-1(e)(1)(v), and Rev. Proc. 93-272 effectively define a capital interest as one that, at the time of receipt, would entitle the executive to notice of meetings; inspect the books and records; hold the company, the controlling parties, or the equity owners accountable for fiduciary duties; and possibly voting rights. On the other hand, plans that do not provide actual or potential ownership are only contractual obligations which, while subject to the implied covenants of good faith and fair dealing, do not subject the company or the owners to any of the above obligations.

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1 For purposes of this article, all references to partnerships and LLCs are to partnerships and LLCs that are taxable as partnerships for federal income tax purposes and have not elected to be treated as corporations.

Characteristics of Equity Bonus Plans

An equity grant may be based on a number of factors including the executive's role and position within the company, the company's performance, the performance of the executive's division or the executive's job performance. Generally, the executive's equity interest will be subject to a substantial risk of forfeiture that lapses upon vesting and to restrictions upon transferability that never lapse. Moreover, the executive is often required to sell the vested equity interests upon the executive's termination either to the company or the other equity owners.

If the executive receives a profits interest in a partnership or in an LLC for the performance of services, Rev. Proc. 93-27 sets forth the position of the IRS that if the executive receives a profits interest for providing services to or for the benefit of the partnership or LLC in a partner or member capacity or in anticipation of becoming a partner or member, then the grant of the profits interest to the executive is generally not taxable, and the executive will not recognize income upon grant of the profits interest. Rev. Proc. 93-27 contains three exceptions to the general rule if: (a) the profits interest relates to a substantially certain and predictable stream of income from partnership assets; (b) within two years of receipt, the executive disposes of the profits interest; or (c) the profits interest is an interest in a "publicly traded partnership within the meaning of §7704(b).

Rev. Proc. 2001-43 provides further guidance on the treatment of profits interests that are subject to vesting requirements. It states that Rev. Proc. 93-27 applies at the time of grant of profits interests even if the profits interest is not vested if all of the requirements of Rev. Proc. 93-27 are satisfied and the following additional requirements are satisfied. First, the executive is treated as an owner of the profits interest from the date of grant and the executive takes the executive's distributive share of the income and loss of the company. Second, neither the company nor its equity owners claims a deduction either at the time of grant or at the time the interests vests.

If the equity interest is subject to a substantial risk of forfeiture, the executive does not have to recognize income until the substantial risk of forfeiture lapses. The company does not receive a deduction until such time as the executive recognizes the income. However, the executive may elect under §83(b) to recognize income at the time of the transfer, thereby causing subsequent appreciation to be taxed at the capital gains rate. This election is typically made in circumstances in which substantial appreciation is anticipated before the applicable restrictions lapse. An §83(b) election does entail risk because no subsequent deduction is allowed for diminished value if the value of the equity interest declines or the equity interest is forfeited.

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3 Regs. §1.61-2(d)(4). The use of equity interests in closely held businesses that are not subject to restrictions is unlikely.

4 §83(c)(1).

5 §83(a)(1).

6 §83(b).

7 §83(b).

8 This election must be made within 30 days after the transfer of the stock, and once made is irrevocable.

9 Regs. §1.83-2(f).


The company has flexibility to establish restrictions in the bonus plan that balance the executive’s desire for current compensation with the company’s long-term goals. Typically, equity bonus plans establish minimum holding periods in order to create an incentive for the executive to remain with the company and take a long-term view of the company’s success. Equity bonus plans also are frequently subject to vesting provisions, which provide that the executive will not have an indefeasible right to the equity interest until expiration of a certain period of time or the occurrence of certain events. The most common vesting methods involve vesting over a fixed period of time or “cliff vesting,” which provides that all vesting occurs at a certain point or certain points in time. The two methods may also be combined to tailor an equity bonus plan to the company’s and the executive’s desires. The vesting schedule chosen by the company should encompass a sufficient time period to achieve the desired long-term results from the executive. After the equity interests are fully vested, they will typically remain subject to sale obligations to the company or the other owners at predetermined prices upon termination of employment, death, permanent disability, retirement, or resignation and other occurrences.

Equity bonus plans are not subject to any statutory requirements and, thus, are extremely flexible. To increase the effectiveness of the incentive as both a retention and motivational device, vesting can be made contingent upon specific performance targets such as business valuation, net income, or unit profitability. The plan may also provide for negative consequences if targets are not met.

Comparison of Equity Bonus Plans to Alternatives

Equity bonus plans enhance capital accumulation for the executive and provide the company with a cash-free method of recognizing past performance, and thereby creating incentive for future performance. Moreover, the distribution and voting rights that may attach to the equity interest serve as reminders of the executive’s economic interest in the company’s success. Equity bonuses subject to vesting schedules also serve as “golden handcuffs,” encouraging long-term executive employment and discouraging short-term job switching. However, the benefits of equity bonuses are not without cost. Because the executive does not pay for the equity interest, the motivational impact is limited because the executive receives a benefit regardless of the executive’s or the company’s achievements. An equity bonus plan may also make the company less attractive to banks or venture capitalists who do not care for ownership to be given away at no cost. Finally, other equity owners that have invested in the company may resent that the company gave away equity interests to the executive.

EQUITY PURCHASE PLANS

An equity purchase plan is similar to an equity bonus plan except that the company’s equity interests are sold, rather than given, to the executive. The purchase price for the equity interests may be either full market value or a bargain purchase price. In addition, the plan typically will not require the executive to forfeit purchased equity interests if the executive does not meet certain requirements or leaves before vesting.

Tax Consequences

If the purchase price for the equity interest is equal to its fair market value, the sale has no tax consequences. On the other hand, if the executive purchases a capital interest in the company for other than the current fair market value, the difference between the fair market value and the purchase price is taxed as ordinary income to the executive. The company may not claim a deduction for the purchased equity interests unless the executive recognizes income.

Characteristics

While an equity purchase plan typically does not require the executive to forfeit the purchased equity interests, a plan may compel resale upon the occurrence of certain events using a formula that results in a deeply discounted sales price payable over a term of

13 Other than the opportunity cost resulting from the executive’s probably cut in cash wages in lieu of receiving the bonus equity interests.

14 Such a plan differs from an Employee Stock Purchase Plan under §423. Among the requirements of that are first, that the plan involve the stock of a corporation and second, that the plan, with limited exceptions, is open to all employees of the corporation.

15 The equity purchase plan can, however, require the executive to sell the equity interests back to the company.

16 Section 1032 provides that a corporation does not recognize income from the sale of its own shares. However, because there is no corresponding with respect to partnerships or LLCs, it is unclear whether the partnership or LLC should be treated as having made a taxable disposition upon the sale of a capital interest received by the executive.
years.\(^\text{17}\) In order to alleviate the executive’s cash-flow problems, the company may lend the executive all, or part, of the purchase price, or may finance the purchase through installments deducted from the executive’s salary or distributions made with respect to the executive’s equity interest. The purchase price can be set below fair market value to provide a measure of current compensation as well as a long-term incentive. An equity purchase plan may also provide for the purchase of a profits interest in the company.

Comparison to Alternatives

The principal advantage of an equity purchase plan is the affirmative investment of capital in the company by the executive. The investment not only will motivate the executive, but also will provide a strong retention device. On the other hand, the executive may be reluctant to pay for the equity interests from his or her salary and, therefore, may find the plan unattractive.

OPTIONS PLANS

An option is not an equity interest in the company; rather, an option is the grant of a right to purchase the equity interests at a specific price ("exercise price") on a specified future date subject to certain specific terms. Options can be granted based upon a number of criteria, including position, tenure, past contributions, or the expectation of future performance. There are two basic types of option plans: Incentive Stock Options ("ISOs") and Non-Qualified Options ("NQOs"). The primary difference between NQOs and ISOs lies in their flexibility and their tax effect.

Incentive Stock Options

Incentive Stock Options are used primarily for corporations or a partnership or LLC that has elected to be taxed as a corporation. The executive does not recognize income when an ISO is exercised, and upon the eventual sale of the underlying stock, the executive recognizes a capital gain based on the difference between the sales price and the exercise price. There are many statutory requirements for ISOs. However, partnerships and LLCs that are taxable as partnerships cannot issue ISOs.

Non-Qualified Options

NQOs are options that do not satisfy the statutory requirements of ISOs or are issued by companies that are not taxable as corporations. NQOs are more typically used in closely held businesses due to their flexibility.

Tax Consequences of NQOs. NQOs result in immediate taxation if, at the time of grant, the options have a "readily ascertainable fair market value." If the NQOs have a readily ascertainable fair market value, the executive recognizes ordinary income equal to the difference between the fair market value of the options and the exercise price of the options, if any; the company receives a corresponding deduction.\(^\text{18}\) While the difference between the fair market value of the NQOs and the exercise price is taxed at ordinary income rates, the compensatory component of the NQOs would not be subject to further taxation.\(^\text{19}\) In closely held businesses, the grant of NQOs results in the immediate recognition of taxable income because the options will not have a readily ascertainable fair market value.\(^\text{20}\)

If the NQOs have no readily ascertainable fair market value on the date of grant, the executive will recognize income equal to the difference between the fair market value of the underlying equity interests and the exercise price of the options on the date the NQOs are exercised and are not subject to a substantial risk of forfeiture.\(^\text{21}\)

The company is entitled to a business expense deduction when the executive is required to declare ordinary income, and the deduction is limited to an amount equal to the ordinary income declared by the executive.\(^\text{22}\) However, the deduction is allowed only to the extent that the executive's total compensation is "reasonable."\(^\text{23}\) Moreover, if the executive is treated as an employee, the company is also subject to withholding requirements applicable to employee compensation. When the executive eventually sells the equity interests, the excess of the sales price over the sum of the exercise price and ordinary income previously rec-

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\(^\text{17}\) Although the executive can enjoy all the privileges of ownership, such as the right to vote and receive distributions or dividends, before "vesting," this plan may be particularly unattractive to the executive unless the executive is afforded an opportunity to buy the shares at a truly bargain price.

\(^\text{18}\) Regs. §1.61-2(d)(1).

\(^\text{19}\) §§83(e)(4).

\(^\text{20}\) The regulations explain that the value of an option is not readily ascertainable unless the option is actively traded on an established market. Clearly, this is a condition that a closely held business seldom can satisfy. In the alternative, the NQO may have a readily ascertainable fair market value if it meets each of four separate conditions: (1) the option is transferable by the optionee; (2) the option is exercisable immediately in full by the optionee; (3) neither the option nor the underlying equity interest is subject to any restriction or condition, other than a condition to secure the payment of the purchase price, which has a significant effect on the option's fair market value; and (4) the fair market value of the option privilege itself — as distinguished from the underlying equity interests — is readily ascertainable. Regs. §1.83-7(b).

\(^\text{21}\) Regs. §1.83-1(a).

\(^\text{22}\) §§83(h).

\(^\text{23}\) §162(a)(1).
Transferability. The executive may be able to substantially reduce federal estate and gift tax liability by transferring the NQOs during the executive’s lifetime. Typically, the most advantageous time of transfer is shortly after grant of the NQOs. The executive may transfer the NQOs directly to family members, or, possibly, to a family limited partnership.

The value of a gift of NQOs is the fair market value of the NQOs on the date of the gift. Typically, this value is substantially less than the value of the equity interests when the NQOs are exercised. Following the gift, any further appreciation in either the value of the options or the underlying equity interests would not be subject to further estate or gift tax. However, there is a risk that the underlying stock price or the equity interests may never reach the exercise price. In such instances, the Code does not permit the executive to reclaim the lost exemption or recover any gift tax that was paid. The gift of the NQOs should not create any income tax liability and does not affect the income tax consequences to the executive upon exercise of the NQOs by the family member. The IRS, however, takes the position that the gift of the NQOs is not complete until the NQOs are no longer subject to a substantial risk of forfeiture.24

Comparison of ISOs and NQOs

Gain on the sale of the stock purchased pursuant to an ISO is taxed at the capital gains rate. Given capital gains rates as low as 15%25 and ordinary income tax rates as high as 35%,26 the executive not only receives a benefit from the company but also pays the historically lower rate applicable to capital gains. Although the company receives no corresponding deduction, the company benefits by compensating the executive without a cash outlay and without paying withholding taxes that may accompany payment of regular compensation. Moreover, the holding period requirements create an incentive for the executive to remain with the company and to focus on long-term growth and strategy.

The major disadvantages of ISOs are (1) that they are available only to partnerships or LLCs that elect to be taxed as corporations,27 and (2) the burdens of the strict ISO requirements. The company may not grant ISOs that have an exercise price less than the current fair market value of the stock; therefore, an ISO will not provide the executive any compensation unless the company’s value increases. The company may also find that executives do not consider ISOs to be “compensation” because the options have no eco-

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25 0% for taxpayers who are in the 10% and 15% ordinary income tax brackets. §1(h).
26 §1. Absent Congressional action, in 2013, the capital gains rate will increase to 20% and the highest marginal ordinary income tax rate will be 39.6%.
27 A limited liability company or partnership that elects to be taxed as a corporation may also use ISOs.
nomic value when granted. As with all equity-based plans, the executive may become a partner or member, diluting existing partners or members and entitling the executive to certain rights including the right to hold majority partners or members, members, or general partners and officers accountable for fiduciary obligations.

ISO requirements have several features that the executive may also find troublesome. The executive may pay for the stock only by certain statutorily prescribed methods. Next, holding period requirements that prevent the executive from disposing of the underlying stock within two years from the grant date or one year from the exercise date can frustrate the executive's ability to take advantage of market upswings. Furthermore, the lack of transferability of ISOs eliminates the executive's ability to transfer the ISOs to descendents to reduce the executive's estate for estate tax purposes. Finally, the executive may owe tax upon exercise, to the extent he or she is subject to the AMT.

Both ISOs and NQOs are advantageous because the company does not directly pay for the benefit realized by the executive. This feature is particularly attractive to early growth stage businesses for which compensation of talent must be balanced with the need for capital. The tremendous wealth-building potential offered by ISOs and NQOs is especially effective in attracting executive talent that is willing to sacrifice short-term compensation for a chance to participate in the company's upside. Moreover, ISOs and NQOs provide a non-cash method of awarding bonuses for attaining goals and motivation for continued performance.

Because there are a few specific legal requirements for NQOs, their range of features is quite broad. NQOs enable entities other than corporations to compensate individuals via options. Moreover, NQOs provide a non-cash mechanism to compensate individuals who do not qualify as common law employees, such as directors and strategic third parties. Finally, vesting and holding periods result in capital investment by executives in the company, further linking ownership and management goals. Overall, the flexibility in pricing, holding periods, permissible participants, and times and methods of exercise may make NQOs more practical vehicles than ISOs for tailoring a plan to a company's needs to attract, retain and provide incentives for employees.

Notwithstanding the aforementioned benefits, NQOs impose costs, which both the closely held busi-

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28 The right to receive property (other than cash) must be includable in income under §83. §422(c)(4).
29 The equity owners, of course, do pay in the form of dilution in the value of their ownership of the company.
30 Only common law employees of a corporation, its parent, or subsidiaries are eligible for ISO treatment. §422(a).
31 PLR 9040035.
32 If equity interests are received, then §83 will govern its taxation.
establishes a phantom ownership account for the executive and credits his or her account with the fictional “interests” as they are granted or purchased. The company promises to pay the value of all vested fictional interests in the company at a specified future date. Phantom ownership plans may be settled in cash, equity interests, or some combination thereof.\textsuperscript{13}

In their simplest form, the benefit provided by the phantom ownership plan equals the appreciation in the fair market value of the fictional interests in the company between the date the interests are granted and the date the benefit is paid. Other phantom ownership plans attempt to replicate actual ownership by paying the value of the hypothetical interests granted at the settlement date. Some plans also make annual payments to the phantom owners that replicate the distributions made to the company’s actual equity owners. The phantom distributions are taxable to the executive as ordinary income and are deductible by the company as compensation.\textsuperscript{34} If the fictional interests in the company are used as part of a bonus plan, creative vesting schedules may be used in order to retain and further motivate the executive.

Comparison of Phantom Ownership Plans to Alternatives

For those closely held businesses that desire to offer executives the opportunity to share in the company’s success without giving up an actual equity stake in the company, phantom ownership plans provide ideal flexibility. Because phantom ownership plans are contractual arrangements, the company is not subject to the legal limitations that apply to equity. Accordingly, the plans may be structured creatively, with measurement criteria and vesting schedules that act as “golden handcuffs” to retain valued executives and to align the executives’ interests with those of the company. Finally, the company can offer identical economic compensation to its executives without the burdens of the obligations owed to actual equity owners that exist in equity plans.

The disadvantages of phantom ownership plans are the executive’s perceptions regarding “true ownership” versus economic equity and compensation which leads to ordinary income as opposed to capital gains afforded by some equity plans.

\textsuperscript{33} For closely held companies, most phantom ownership plans do not provide the option to receive equity interests in the company, because the company does not want to give up equity in the company.

\textsuperscript{34} Such phantom dividends or distributions can be paid in cash or in the form of credits to the executive’s phantom stock account. If the agreement is properly drafted, the executive will avoid taxation on these dividend or distribution equivalents until they are actually received, just as taxation is deferred on the underlying grants.

APPRECIATION RIGHTS PLANS

Appreciation rights are a contractual obligation between the company and the executive that entitles the executive to cash or actual equity interests in the company\textsuperscript{35} based on the appreciation in the designated measuring factor.

Tax Consequences of Appreciation Rights Plans

The tax treatment that applies to phantom ownership plans generally also applies to the grant of appreciation rights in the company. The grant of appreciation rights is not taxed as a transfer of property in connection with the performance of services (i.e., compensation). Therefore, when the appreciation rights lead to payments or the issuance of actual equity interests, the executive recognizes ordinary income equal to the cash plus the fair market value of any property received, and the company is entitled to a corresponding deduction.\textsuperscript{36} The company is also subject to withholding requirements.

Characteristics of Appreciation Rights Plans

Although the value of appreciation rights may be based on any measurable factor, such as gross sales or net profits, most appreciation rights plans are valued based on the value of the company. The company may pay the benefit on a fixed settlement date or upon the occurrence of certain events such as the sale of the company.

As with options, appreciation rights may be subject to vesting periods that allow the company to tie the benefits to long-term performance and employment. Finally, appreciation rights are often utilized when options are granted to the executive in order to alleviate the cash flow problems facing the executive at the time options are exercised.

Comparison of Appreciation Rights Plans to Alternatives

Appreciation rights plans are ideal for closely held businesses that do not want to relinquish equity in the company. Due to their contractual nature, appreciation rights have flexibility, which allows the company to approximate the compensation plans of competitors and target incentives to areas that require focus. Furthermore, the executive does not receive any of the

\textsuperscript{35} Closely held companies rarely issue actual equity interests.

\textsuperscript{36} §61(a)(1); Rev. Rul. 80-300, 1980-2 C.B. 165. If restricted property is received, then §83 will govern its taxation.
ARTICLES

rights of an actual equity owner. From the executive’s perspective, appreciation rights may be less attractive because of the ordinary income tax consequences and the perception that the company is not willing to give the executive "true equity ownership."

PERFORMANCE UNIT PLANS

Whereas most incentive compensation plans base the plan’s economic reward on the overall performance of the company, a performance unit plan uses a more specific measurement, such as the executive’s performance, the performance of the executive’s division, or the attainment of certain targeted company goals that are directly related to the executive’s performance.

In general, a performance unit is a benefit based on specified criteria such as earnings, sales, growth, production, return on equity, return on investment, profit margin, or other specific measurements that the executive’s performance directly affects. Typically, the measurement is taken over a period of time, providing an incentive predicated on long-term results.

Tax Consequences of Performance Unit Plans

Performance unit plans are generally taxable to the executive and the company in the same manner as appreciation rights and phantom ownership plans. Thus, the benefit is taxable as ordinary income to the executive when it is actually or constructively received and the company is entitled to a deduction when it pays the benefit. The company is also subject to withholding requirements.

Characteristics of Performance Unit Plans

Under most performance unit plans, the company awards the executive a number of units that are valued at a predetermined price at the beginning of a performance period. The number of performance units may vary with performance, further rewarding exceptional performance. Payments to the executive for some or all of the performance units is usually tied to the time the performance goals are achieved. The company can structure the performance goals with certain levels likely to be attained, virtually ensuring some additional compensation, and other thresholds that require outstanding performance to reach higher compensation levels.

To enhance the retention elements of the plan, performance can be measured over long periods of time. "Golden handcuffs" can also be created by establishing a deferred payment mechanism or a vesting schedule, obligating the executive to work with the company for a specified number of years following achievement of the awards or until retirement before payouts are completed. Should the executive’s employment with the company be terminated for any reason, the unpaid benefits can be forfeited.

Comparison of Performance Unit Plans to Alternatives

As long as the closely held company can create a defined plan with quantifiable goals, performance unit plans will be among the most effective mechanism for tying benefits to performance. In addition, the necessity of valuing the company, which could adversely affect other equity owners for estate and gift tax purposes, can be eliminated by using more readily ascertainable payment criteria. Performance unit plans may also better align the executive’s interests with the interests of non-management employees by linking the executive’s incentive compensation to the criteria that will be used as the basis for bonuses to the personnel under the executive’s charge.

Disadvantages of performance unit plans stem from the difficulties inherent in targeting performance goals and designing a plan to focus the executive to attain the desired results, the potential deviation of the executive’s interests from those of the equity owners, from the plan’s customary lack of a capital investment requirement and the fact that the executive is taxed at the historically higher ordinary income rates.

CHOOSING THE RIGHT ALTERNATIVE

The decision of which plan or plans the company should offer its executives depends largely on four considerations: (1) whether the current equity holders are willing to give up equity interests in the company and whether the executive desires to receive them; (2) the goals and objectives of the company to which the company wishes to tie the executive; (3) the effect of the plan on the company’s financial statements and of various laws; and (4) the cash and tax needs of the executive.

37 Of course, the achievement of performance goals must still be monitored and valued, but the measurement of the performance criteria is likely to be less burdensome than an appraisal of the company.

38 One reason why the equity and equity-like incentives are so popular is that owners are most concerned with appreciation in their company, while achievement of performance goals operate merely as an indirect factor in the company’s value.
Current equity holders must first consider whether they are willing to part with actual equity. There are significant advantages to plans that provide actual equity interests to the executive. First, equity offers the most effective means of retaining the executive. Not only will the receipt of actual equity make an executive less apt to leave the company, but the tax consequences of a sale of the executive’s equity interests following termination makes competing offers less appealing. In addition, by providing the executive with an interest similar to that of the equity owners, the company ensures that the executive’s efforts will be channeled toward actions that increase the overall value of the company. Most importantly, the company will preserve cash for investment and expansion.

Actual equity, however, may create additional operational and legal problems for the company. First, the company may be required to obtain the executive’s approval for such things as issuing additional equity or engaging in major transactions. While these rights can be reduced or eliminated in the partnership or operating agreement, the executive will still have rights to notice, will have access to books and records, and will benefit from fiduciary responsibilities of others. Finally, the company must develop a plan (i.e., a buy-sell agreement) to reacquire the equity interests of the executive upon termination to avoid harmful actions by potentially bitter or hostile minority equity owners.

The company needs to closely consider its long- and short-term goals in order to establish the incentive plan or plans that will best achieve the objectives. Some of the relevant factors include: who should participate in the plan; whether a capital investment by the participants should be required; whether the plan should require extended employment with the company; what terms apply to termination of employment and what benchmarks should form the basis for determining the amount of the compensation. Only after the company has answered these questions will it be able to design the appropriate plan.

For those closely held companies concerned that incentives not directly tied to personal performance are ineffective or may operate as disincentives, performance unit plans offer an ideal alternative. Companies desiring to align the interests of the equity owners and the executives will prefer option plans, bonus plans, or phantom ownership plans, which offer the identical upside for executives and equity owners. Combinations of the various plans can be used to create a mix of incentives to direct and retain executives.

Effects of benefit plans on financial statements and compliance with various statutes such as ERISA or securities codes may also be relevant. For example, the effect on the income of the company may affect future plans for outside financing, sale, or public offering. Finally, the company should consider the needs of the executive in designing incentive plans to properly motivate the executive.

The company also may consider combining equity-based and non-equity plans to take advantage of the benefits of each type of plan. A common example is a combination of an NQO with appreciation rights. Such a plan could require the executive to exercise the NQOs concurrently with payments under the appreciation rights plan, thereby providing the executive with cash to pay taxes, providing the company with a source of the executive’s funds to meet withholding requirements, and generating a deduction for the company.

**Beware of §409A**

Section 409A of the Code imposes strict rules on deferred compensation arrangements between the company and executives. The definition of deferred compensation is broad and includes items that may not commonly be thought of as deferred compensation. If the requirements of §409A are not met, it imposes severe tax consequences on executives. These severe tax consequences include a 20% penalty tax, immediate taxation on vesting, and interest at the federal underpayment rate plus one percent. Section 409A also imposes reporting and disclosure obligations on companies. In designing any plan, both the company and the executive need to ensure that the incentive plan is subject to §409A or if the incentive plan is subject to §409A, that the requirements of §409A are satisfied.

**CONCLUSION**

Incentive plans are effective tools for the closely held business to secure, motivate, attract, and retain executives, as well as to align the company’s interests with those of the executive. Proper structuring and implementation of incentive plans can maintain a successful management team for years to come, effectively motivate employees to reach new performance levels, and “lock in” executives by making competing offers less attractive.

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41 An executive may have performed well, but the value of the company depreciated for other reasons. Conversely, the executive may have performed poorly, yet he or she still receives a windfall as a result of superior performances by others.