3 Incentive Compensation Alternatives To Consider

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While stock options may be the typical "go-to" form of employee incentive, a company may have reason to seek alternatives. Many employers provide employees with equity-based compensation such as stock options or restricted shares, but often employees are not receiving the value these incentives were intended to provide. In other cases, a company may want to avoid granting actual equity or supplement equity awards with additional incentives. For any of these reasons, employers should consider new approaches to help retain employees and reward performance.

Generally, employees only see benefits from stock-based compensation when their companies go public or are sold. Many employees, however, never exercise stock options, a February report by Schwab Stock Plan Services noted. Only half of stock compensation program participants were confident about making the right decisions about their plan, Schwab found. Employers' concerns about whether employees value stock options could be a reason that their use has declined in recent years, according to a 2017 report from FW Cook.

Equity Compensation Alternatives

To keep employees engaged, companies should consider offering equity compensation alternatives. Plan design should be driven by factors such as deciding who can participate, what they will receive, when the award will be paid and what goals the company wants to achieve. Common equity compensation alternatives include short-term bonus plans, phantom equity and supplemental executive retirement plans, or SERPs, which we discuss in more detail below. In short, each of these plans can provide additional cash compensation that is tied to performance and/or continued service to the company. The Employee Retirement Income Security Act and the tax code govern how these arrangements can be structured. Phantom equity, bonuses and SERPs may be treated as nonqualified deferred compensation restricted by Section 409A of the Internal Revenue Code unless they are structured to fall within an exception.

Avoiding Section 409A Constraints

Section 409A regulates payments of "nonqualified deferred compensation," which, in general, includes amounts for which there is a legally binding right to payment in a future year (subject to numerous exceptions). If Section 409A is violated, potential penalties include accelerated income tax, a 20 percent excise tax on the payee (in addition to ordinary income tax), interest, and related costs and penalties, plus a 5 percent additional tax for any California taxpayer. Although the 20 percent excise tax is imposed on the payee, not the company, the company could have liability for failure to withhold income tax (but not the 20 percent excise tax), interest, and related costs and penalties. These potential consequences highlight the importance of proper planning and legal review to avoid costly tax implications.

Complying with Section 409A means, among other things, specifying the time and form of payment in a proscribed manner and having limited ability to make changes to the program once it is established. There are also reporting requirements. Exceptions apply, though.

A common workaround to Section 409A's constraints is the short-term deferral exception, which requires that employees bear a substantial risk of forfeiture (i.e., loss) and that payment be made within a relatively short time after forfeiture risk ends. Payment must be made within two and a half months after the end of the year in which the payment vests. This is most commonly done by requiring payment by March 15. One way to achieve a substantial risk of forfeiture is by requiring continued employment through the date of payment. Use of the short-term deferral exception is more typical in the context of short-term bonus plans and phantom equity arrangements than in SERPs.

Given the number of design considerations and planning opportunities for each of these equity compensation alternatives, we delve into each in further detail.

Bonuses as an Incentive and Retention Tool

One alternative a company can use to attract and retain employees beyond standard equity grants is a short-term bonus plan. A bonus plan is advantageous because it can tie the amount of the bonus to the performance of the company, similar to equity. Requiring continued employment on the date of payment can incentivize employees to remain with a company. A bonus plan also can help attract prospective applicants. There is flexibility to structure a bonus plan in ways that maximize the goals of a company.

In designing a bonus plan, a company should consider the business goals, financial constraints of the company, desired results from employees, market trends, and administrative oversight implications. In addition, a company will need to determine who can participate, what they get, when it will be paid and why to offer this benefit. A bonus is taxable to the employee as ordinary income when it is paid (and the company can take a corresponding deduction).

Common decision points for a company involve determining the amount of a bonus for each participant (which can vary), whether it should be a percentage of base salary or a percentage of a pool, what the performance metrics are, and how the award is treated upon a termination of employment. Criteria that tie both to the performance of the company as well as individual performance provide the greatest incentive for employees to work to earn the bonus and to grow the company. Tax rules also come into play in designing a bonus program. A bonus plan can be structured as an annual award (the terms of which can change yearly), which typically is designed to fall within an exception to Section 409A. Alternatively, a bonus plan can be structured as an award that pays out over multiple years, which may be required to comply with Section 409A unless it has a substantial risk of forfeiture.

Often, bonuses are structured to meet the short-term deferral exception to Section 409A. A popular approach to creating a substantial risk of forfeiture is to require continued employment through the date of payment, unless termination is due to a termination without cause or a resignation for good reason and payment occurs within two and a half months following the year of termination. Even bonuses that are structured to pay out in tranches over a fixed period of time can be structured to be exempt from Section 409A to the extent continued employment is required on the date of payment.

While it can be fairly straightforward to structure an arrangement to fit an exception to Section 409A, that structure may not meet the company's goals or desired business terms. If an arrangement does not qualify for an exception to Section 409A, such as if the company desires to award a bonus in one year and pay it out in installments over five years, then it must be structured to comply with Section 409A. This means there must be a specified time and form of payment, subject to certain rigid requirements with a limited ability to make changes. While this still can work, it adds complexity.

Another possible way to incentivize and retain employees is through phantom equity.

The Power of Phantom Equity

So-called phantom equity has become a popular alternative for tying employee compensation to the value of the company. Phantom equity is not real equity, since it does not confer equity ownership in the company. Instead, its value is normally measured by the value of a share of the company's common stock, and typical vesting and transferability restrictions apply. Companies frequently structure phantom equity to pay out on a change in control of the company, often with the requirement that the individual still be employed at that point. Phantom equity features benefits for both employees and companies.

From an employee perspective, phantom equity removes the decision-making aspect that can be challenging with options, such as when to exercise. It also does not require the employee to make any out-of-pocket payment (such as an exercise price), making it more attractive than a typical stock option grant.

From a company standpoint, it is a valuable tool that is used to retain employees by tying incentives to a future sale. It also simplifies the company's ability to sell in the future by limiting the number of shareholders involved.

Phantom Equity in Lieu of Actual Equity

Companies have a fair degree of flexibility when granting phantom equity with respect to who is eligible to participate and the terms of vesting and payment. However, there are certain tax challenges involved if the phantom equity is structured as deferred compensation, subjecting the arrangement to the requirements of Section 409A.

Phantom equity does not confer any actual ownership rights on the recipient and therefore, the company retains decision-making authority. The value of phantom equity is similar to actual equity in that the value of phantom equity is also tied to the value of the company, incentivizing employees to help promote the growth and success of the company. It mimics the financial award associated with equity but avoids many of the risks and liabilities connected with actual ownership. For example, recipients are not exposed to corporate governance issues or required to personally buy into the company.

Phantom Equity Mechanics

The value of phantom equity typically is measured by the value of a share of a company's common stock. Participants in a phantom equity plan generally receive a percentage of a "pool." This is typically either (1) based upon a percentage of net proceeds upon a change in control (full value award), or (2) based upon a percentage of net proceeds that exceed a certain threshold upon a change in control (often tied to the value of the company on the date of grant). Phantom equity generally vests over time, subject to continued employment, and payment often is triggered upon a change in control of a company.

From a tax perspective, the company generally receives a deduction at the time payment is made and any payment received by an employee is taxed as ordinary income. The recipient of phantom equity has no tax upon grant of the phantom equity and will only owe tax at the time of payment. Recipients of phantom equity do not come out of pocket for any costs. It also can be structured to be forfeited without any penalty to either the company or the recipient if the employee leaves the company.

Important Design Considerations

When implementing a phantom equity plan, a company faces many important decision points. Consider whether to require continued employment through the date of payment. What should be the impact of a termination without cause, resignation for good reason, and a termination due to death or disability? Is a change in control required to happen by a certain date for the plan to pay out? In addition, are there contingent payments, such as an earn-out, that participants in a phantom plan would share in and if so, is that paid at closing or as shareholders get paid?

Depending upon how a company wants to structure this arrangement, it must either comply with or be exempt from Section 409A. Structuring the arrangement to be compliant with Section 409A requires having a specified time and form of payment that complies with the strict requirements of Section 409A. If possible, it is efficient to structure a phantom equity arrangement to be exempt from Section 409A by making the payments subject to a substantial risk of forfeiture (such as continued employment through the date of a change in control) and paid by March 15 of the year after the year in which it vests (the short-term deferral period).

If a phantom equity plan is designed to pay out after termination of employment, the company will need to consider the applicability of ERISA. An exemption may be available, but availing itself of a particular exemption may require a company to change its plan design (such as by limiting who may participate in the plan).

In addition to, or in lieu of, phantom equity and short-term bonuses, a company may want to explore SERPs as a means of employee retention and incentives.

Use of Deferred Compensation to Attract Talent

Companies looking for creative ways to provide additional incentives for employees that align with the goals of a company may want to consider a supplemental executive retirement plan. A SERP is a nonqualified deferred compensation plan that allows compensation to grow on a tax-deferred basis. SERPs can be an alternative or supplement to offering employees equity. Unlike stock options, for example, SERPs do not require employees to incur any out-of-pocket costs. Offering a SERP can be an attractive benefit to executives and create a more well-rounded compensation package. Depending on its priorities and reasons for implementing the program, a company can design a SERP to be based upon performance rather than years of service to promote growth of the company and stronger individual performance by employees.

SERPs provide participants with retirement income beyond what they can defer under a qualified plan such as a 401(k) due to contribution limits on qualified plans. SERPs help when a company is looking to provide additional retirement incentives to a select group of highly compensated employees. Tax rules and ERISA need to be considered in designing SERPs. While the arrangements are designed to be ERISA-exempt, they are typically structured to be compliant with Section 409A, instead of relying on an exemption. This renders SERPs subject to Section 409A's limits for making deferrals to the plan and receiving payment from the plan.

A SERP can be designed to mirror the terms of a company's existing qualified pension plan, or it can be negotiated with a particular individual, resulting in a potentially complex arrangement. SERPs normally are funded by the employer and structured to pay a benefit in the future. The assets of a SERP must be available to the creditors of the company.

One benefit of using a SERP is that it is typically exempt from ERISA (although it is still subject to the administrative and enforcement provisions of ERISA). As a result, it is not subject to the nondiscrimination rules that apply to qualified plans. A SERP is typically offered to select executives, determined in the discretion of a company. SERPs generally are designed as "top-hat" plans. To qualify as a top-hat plan, a SERP must be unfunded and maintained by an employer primarily for providing deferred compensation to highly compensated employees or a select group of management. To avail itself of the top-hat exemption to the ERISA reporting and disclosure rules, the company would file a one-page summary with certain requisite information with the U.S. Department of Labor within 120 days of creating a SERP.

SERPs also are subject to limitations imposed by Section 409A. A SERP must have a plan document that complies with the requirements of Section 409A, including a specified time and form of payment. The time and form of payment must be specified no later than (1) the time the legally binding right arises and (2) the time the service provider's election would be due, if an election were available. The timing of payment must fall within the parameters imposed by Section 409A, which identifies certain permissible payment events (including a fixed time/schedule or a separation from service that meets the applicable Section 409A definition).

SERPs are viewed as beneficial to the employees as they allow for the benefit to grow on a tax-deferred basis. From the company's perspective, a deduction is available only when the SERP benefit is paid. The company is responsible for paying taxes on any earnings on the SERP benefit. Employees normally are only taxed upon distribution from a SERP. A SERP is taxed as ordinary income. Distributions from a SERP cannot be rolled over into another retirement plan.

While there are many advantages of offering a SERP, a SERP does carry certain risks. If a company goes bankrupt or otherwise is insolvent, the amounts set aside under the SERP are subject to the claims of creditors. Executives who thought they had specific retirement payments they could count on may find they ultimately do not. Even so, many companies find SERPs to be a useful aid in retaining employees and recruiting new hires.

As we have discussed, though equity-based compensation is a common form of employee incentive, employers are not limited to that. Alternatives such as SERPs, phantom equity arrangements and bonus arrangements can provide flexible solutions, as long as they are structured and administered to comply with applicable laws. In seeking ways to attract, retain and motivate employees, companies and their counsel can employ a thoughtful and wise approach to identify company goals and design plans that can help achieve them.

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