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Chapter 13

Summary of Equity-based Executive Compensation Programs

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SUMMARY OF EQUITY-BASED EXECUTIVE COMPENSATION PROGRAMS

Long-term incentive programs are designed to afford key employees an opportunity to accumulate significant capital and to align their interests with those of the shareholders. Long-term equity incentive programs are instituted for various reasons, including (i) to attract and retain key personnel, (ii) to reward executives for their contribution to the Company's growth and success, (iii) to encourage loyalty and performance on the part of executives, and (iv) in some cases to encourage attainment of specific performance goals.

There is a wide choice of programs that fall under the general heading of long-term incentive programs. This chapter briefly describes the most common types of equity-based long-term incentive programs and the tax consequences of each type of program. Many of these programs, such as nonqualified and incentive stock options and restricted stock plans, involve the issuance of stock to employees. Others, such as stock units and performance share plans, may or may not involve the issuance of stock to employees, depending on the chosen plan design.

Before a public offering, the equity compensation plan may give the Company a right of first refusal with respect to all stock issued under the plan, and the Company may have the right to repurchase stock issued under the plan if the employee terminates employment. Stock received upon exercise of an option or payment of an equity grant is often subject to a shareholders' agreement if the company's stock is not publicly traded.

The discussion that follows is necessarily general. Corporate, accounting, securities, and other nontax considerations of these arrangements are not discussed in this chapter. Special requirements for incentive programs of publicly held companies are also not discussed in this chapter.

Nonqualified Stock Options

Characteristics

Nonqualified stock options may be granted to employees, directors, and consultants (the term "employee" is used throughout this summary, but all grants other than incentive stock options may be awarded to nonemployee directors or consultants). Under a nonqualified stock option, the employee is granted an option to acquire employer stock at a fixed exercise price. The exercise price may be equal to or greater than the fair market price of the stock at the time of the option grant. The option exercise period can be any period of time, with 10 years being the most common.

Stock options can vest over a period of time based on continued service or, if desired, based on achievement of performance goals. The right to exercise an option may be extinguished on termination of employment.

Tax Effect

Assuming that the option is not transferable and does not have a readily ascertainable fair market value at the date of grant and that the requirements of section 409A of the Code (as described in the next section) are met, no income will result to the employee upon the grant of an option. Except as described in the next section, upon the exercise of a nonqualified stock option, the amount by which the fair market value of the shares on the date of exercise exceeds the option price is taxed to the employee as ordinary compensation income. When the employee sells shares issued upon exercise of the option, the employee will realize capital gain or loss (long-term or short-term, depending on the length of time the shares were held) in an amount equal to the difference between the employee's tax basis in the shares (ordinarily, the fair market value at the time of exercise of the option) and the selling price.

The Company generally will be entitled to a tax deduction in the amount of the ordinary compensation income recognized by the employee at the time the employee recognizes income. The Company is not entitled to any tax deduction with respect to capital gains realized by the employee.

If the stock received upon exercise of the option is "restricted stock," taxation to the employee and deductibility by the Company is generally delayed until the restrictions lapse (see section later in chapter titled "Restricted Stock").

Section 409A Ramifications

Section 409A of the Code imposes requirements on deferred compensation and applies to a broad range of nonqualified deferred compensation arrangements, including stock options and stock appreciation rights (SARs) with an exercise price that is less than the fair market value of the stock on the date of grant.

If deferred compensation does not meet the requirements of section 409A, the employee will be required to include the deferred compensation in income as of the date on which the amounts are no longer subject to a substantial risk of forfeiture. In addition to current income tax, the individual will be required to pay a 20% additional tax on the amount required to be included in income, plus interest.

In order to comply with section 409A, the exercise price of nonqualified stock options and SARs must be equal to or greater than the fair market value of a share of the stock on the date of grant. Final regulations recently issued by the Internal Revenue Service relating to section 409A set forth valuation requirements that must be met for the valuation of stock underlying stock options and SARs. Exhibit A at the end of this chapter sets forth a brief summary of these requirements.

Under the section 409A regulations, for a privately held company, the stock that underlies stock options and SARs must be common stock and may not have any preference rights. In general, equity rights on subsidiary stock may not be granted to employees of the parent company.

Incentive Stock Options

Characteristics

Under the Code, incentive stock options (ISOs) may only be granted to employees of the employer and its parent and subsidiary corporations. Under an ISO, the employee is granted an option to purchase stock of the employer corporation at a fixed exercise price. The exercise price must not be less than the fair market value of the shares at the time of the option grant, and the exercise price for 10% shareholders must be at least 110% of the fair market value of the stock on the date of grant. The option period cannot exceed 10 years (five years for 10% shareholders).

The aggregate fair market value of the stock (determined at the time the option is granted) subject to ISOs that become exercisable for the first time by an employee in any calendar year may not exceed $100,000. The plan under which ISOs are granted must be approved by the shareholders.

ISOs must be exercised within three months after the employee's termination of employment in order to qualify for the favorable tax consequences described in the next section. In the case of the employee's disability, the period following termination of employment within which the ISO must be exercised is extended to one year; in the event of the employee's death, the rule is waived. ISOs can vest over a period of time based on continued service or, if desired, based on achievement of performance goals.

Tax Effect

The employee will not be subject to federal income tax upon the grant or exercise of an ISO, and the Company will not be entitled to a tax deduction by reason of such exercise. If the shares received upon the exercise of an ISO are sold after one year from the date of exercise of the ISO and two years from the date of grant of the ISO, the sale will result in the realization of capital gain or loss in the amount of the difference between the amount realized on the sale and the option price.

Generally, upon a disposition of the shares prior to the end of the ISO holding period (a disqualifying disposition), the employee will recognize ordinary compensation income equal to the lesser of (i) the excess of the fair market value of the shares on the date of transfer to the employee over the exercise price or (ii) the excess of the amount realized on the disposition over the exercise price. Any amount realized on a disqualifying disposition in excess of the amount treated as ordinary compensation income (or any loss realized) will be a long-term or short-term capital gain (or loss), depending on how long the shares were held. The Company may claim a tax deduction on a disqualifying disposition of such shares in the amount of the ordinary compensation income that is recognized by the employee, and at the time so recognized.

When an ISO is exercised, the excess of the fair market value of the shares at the time of exercise over the exercise price is includible in the employee's income for purposes of computing the alternative minimum tax, unless a disqualifying disposition occurs during the same tax year as the ISO exercise.

SARs

Characteristics

Under an SAR, the employee is granted the right to receive an amount equal to the appreciation in the value of a predetermined number of shares from the date of grant to the exercise date. The base price of SARs must be equal to or greater than the fair market value of the stock on the date of grant. SARs can be granted in connection with stock options or independently of stock options. SARs may be payable in cash, company stock, or a combination of cash and stock; although, in order to receive favorable accounting treatment, SARs should be paid in shares of stock.

Tax Effect

See the prior section titled "Nonqualified Stock Options" for a discussion of the requirements of section 409A of the Code applicable to SARs.

If the requirements of section 409A of the Code are met, the employee will not recognize income upon the grant of an SAR. Upon the exercise of an SAR, the employee will realize ordinary income in the amount of the cash and the fair market value of the shares received upon such exercise, and the Company will be entitled to a corresponding deduction. In the event that the employee receives shares upon exercise of an SAR, the shares so acquired will have a tax basis equal to their fair market value on the date of transfer, and the holding period of the shares will commence on that date for purposes of determining whether a subsequent sale of the shares will result in long-term or short-gain capital gain or loss.

Restricted Stock

Characteristics

Under a restricted stock award, shares of stock are awarded to the employee, subject to restrictions. Typical restrictions prohibit transferability of the shares (sale or encumbrance) and impose a substantial risk of forfeiture for a specified period. The shares may vest based on continued service or based on attainment of performance goals. If the employee terminates employment during the restriction period, the shares revert to the Company. During the restriction period, the employee may be given the right to receive dividends on the shares and to vote the shares.

Tax Effect

The employee generally recognizes compensation income at the time the shares are no longer subject to a substantial risk of forfeiture, and the amount of such income is the then full fair market value of the shares (less any amount paid by the employee for the shares). Any dividends received on the shares prior to the lapse of the restrictions will be treated as additional compensation to the employee. The Company generally receives a tax deduction at the time the employee recognizes compensation income.

Under section 83(b) of the Code, the employee can elect to recognize the fair market value of the shares (determined without reference to the effect of the restrictions on fair market value) as income at the date of grant of the restricted stock award, generating a parallel deduction for the Company at that time. If the employee elects such early taxation under section 83(b), there is no further income recognition (and no additional corporate deduction) at the time the restrictions lapse, even if the fair market value of the shares at that time is substantially higher than at the time of award.

When the employee disposes of shares after the restrictions lapse, gain or loss will be long-term or short-term capital gain or loss, with the basis being the amount recognized under the 83(b) election or at the time the restrictions lapse, whichever is applicable, plus any amount paid for the shares. The holding period for capital gains purposes commences at the time of the award if an 83(b) election is made. Otherwise, the holding period begins to run at the time the restrictions lapse.

If the employee elects to pay tax under section 83(b) at the time of an award and then forfeits the shares (for example, by terminating employment), the employee is not entitled to any tax deduction or tax refund on account of the forfeiture. Consequently, an 83(b) election should be carefully considered.

Restricted Stock Units

Characteristics

Restricted stock units (RSUs) are hypothetical shares awarded to an employee. At the end of a designated period, the employee is entitled to receive an amount equal to the value of the shares underlying the RSUs. RSUs may vest based on continued service or the achievement of performance goals. RSUs may be paid in shares of stock or cash, although they receive a more favorable accounting treatment when paid in shares of stock.

An RSU award may provide for additional compensation equal to the dividends that the employee would have received if the RSUs had been actual shares, or for such dividend amounts to be converted into additional RSUs at the fair market value of the shares on the date the dividend becomes payable.

Tax Effect

Payments received by the employee with respect to RSUs are treated as ordinary compensation income. The Company is generally entitled to a corresponding tax deduction.

RSUs may be considered nonqualified deferred compensation under section 409A of the Code. As a result, RSUs generally should be payable as they vest, or they should be payable on a specified date or event permitted under section 409A (such as termination of employment). The

Company can allow the employee to elect, generally before or at the date of grant of the RSUs, the exact date on which the RSUs will be payable.

Performance Shares

Characteristics

Performance shares are typically structured as stock units that vest and are payable based on attainment of specified performance goals. The performance goals may be based on corporate performance goals, such as earnings per share or earnings before interest, taxes, depreciation, and amortization, or based on the employee's personal responsibilities. Typically, performance share programs operate on rolling multiyear cycles (e.g., three-year performance periods), and they allow the value of each unit to be adjusted to reflect the percentage of the performance goals achieved, subject to an aggregate share cap. Payment can be in cash, stock, or a combination of the two.

Tax Effect

The employee is not subject to taxation at time of grant of performance shares. Ordinary compensation income is recognized at the time the award becomes payable. The Company is generally entitled to a corresponding deduction at the time the employee recognizes taxable income.

Performance shares may be considered deferred compensation subject to section 409A in the same manner as RSUs (see prior section titled "Restricted Stock Units").

This chapter is a general survey of long-term equity compensation programs and is not intended to be an exhaustive list. In many cases, programs can be modified or features can be added to meet particular objectives.

EXHIBIT A

Valuation of Company Stock for Options and SARs

The final Treasury Regulations issued pursuant to section 409A of the Internal Revenue Code (the Code) indicate that the following valuation factors should be taken into account when valuing stock of a privately held company for purposes of determining the exercise price of stock options and SARs: (i) the value of the tangible and intangible assets of the company; (ii) the present value of future cash flows; (iii) the market value of stock or equity interests in similar corporations or entities engaged in substantially the same business; and (iv) other relevant factors, such as control premiums or minority discounts. The final regulations indicate that a valuation method will not be deemed reasonable unless all available information material to the Company is considered.

The following valuation methods will be presumed to result in a reasonable valuation, unless the Internal Revenue Service can establish that the use of such method was grossly unreasonable:

(i) A valuation established by an independent appraisal that meets certain prescribed statutory standards under the Code and applicable Treasury Regulations, with such appraised value to be as of a date not more than 12 months prior to the relevant grant date.

(ii) A valuation formula based on the tax principles governing the valuation of shares subject to nonlapse restrictions, provided the formula governs the subsequent transfer of any shares subject to the nonlapse restriction and is used for all compensatory and noncompensatory valuations of the stock, including regulatory filings, loan covenants, and transactions involving the issuance or repurchase of the stock.

(iii) For an illiquid stock not subject to any nonlapse put or call right or obligation (other than a first refusal right) and issued by a startup corporation that has no trade or business that it has conducted for a period of 10 years or more, a written valuation report that takes into account the valuation factors listed above and is prepared by a person with significant knowledge and experience or training in performing similar valuations. However, this valuation method will not be permissible if a change in control or IPO of the stock is reasonably anticipated to occur within the succeeding 12 months.