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Employee Benefits

The Benefits of Using Contract Equity to Attract, Reward, and Retain Key Employees of Closely-Held Companies

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This column compares stock options and phantom equity arrangements to provide a clear understanding of the advantages of a phantom equity arrangement.

In today's hypercompetitive business environment, nonpublic companies are always looking for effective and creative ways of attracting, retaining, and incentivizing their key employees. For many nonpublic companies, the perfect solution is a phantom equity arrangement (also known as a contract equity arrangement). A phantom equity arrangement offers, among other things, flexibility and simplicity, particularly as compared to real equity awards such as stock options. This column will compare stock options and phantom equity arrangements to provide a clear understanding of the advantages of a phantom equity arrangement.

Stock Options

When a company issues a stock option to an employee, it is giving the employee the right to purchase a specified number of shares of the company's stock at a fixed price at a future date. The fixed price is called the "exercise price" or "strike price" and is equal to the fair market value of the underlying stock on the date the option is granted. The future date upon which the employee may exercise his or her option to purchase the stock is typically the vesting date. Once the vesting date occurs, the option remains exercisable for a period of time, such as until the option expires. Once the option is exercised, the employee receives the stock. The employee may immediately sell the stock or hold the stock

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for purposes of selling it later, assuming there is a market for the stock. In the case of a nonpublic company, typically the only time an employee is able to sell his or her stock is when the majority owners decide to sell the company to a third party. As explained below, stock options are highly regulated and complex. Favorable tax treatment is rarely, if ever, achieved. Finally, a holder of real equity has the statutory right in most jurisdictions to review the books and records of the company that has issued the real equity, which is something most private-company issuers would prefer to avoid.[1]

Tax Treatment of Stock Options

One of the perceived advantages that a stock option has to a phantom equity arrangement is the opportunity for the option holder to receive long-term capital gains tax treatment. Such tax treatment is available on the appreciation of the value of the underlying stock from the date the option is granted or exercised, depending on the type of option issued, until the date the stock is sold. However, as illustrated below, in most cases, in order for an option holder of stock in a nonpublic company to receive such favorable treatment, the option holder must pay the exercise price, incur a tax, hold the stock for more than a year, and then hope that the company is eventually sold. For the vast majority of option holders, these costs and risks are simply not worth it. As a result, the vast majority of option holders will exercise their options only concurrently with, or just before, the sale of the company. This results in the appreciation in the value of the underlying stock being taxed as ordinary income, which is no better than phantom equity.

The tax treatment of a stock option depends on whether the option is a nonqualified stock option (also known as a nonincentive stock option) or a qualified stock option (also known as an incentive stock option). In the case of a nonqualified stock option, the option holder does not incur any tax until the option is exercised. When the option is exercised, the option holder recognizes taxable ordinary income equal to the difference between the fair market value of the stock on the date of exercise and the exercise price.[2] Another tax event occurs when the option holder sells the stock.[3] If the option holder holds the stock for more than one year following the exercise date, any gain in the stock's value from the date of exercise to the sale date will be taxed as long-term capital gain, which is subject to favorable tax rates. However, if the option holder holds the stock for one year or less, any gain in the stock's value from the date of exercise to the sale date will be taxed as short-term capital gain and, therefore, subject to the higher rates that apply to ordinary income.

Here is an illustration of the tax treatment of a nonqualified stock option. Suppose a stock option to purchase one share of stock is granted

to Employee X. The exercise price of the stock option is $5 and the option vests in three years. Employee X does not incur any tax when the stock option is granted or when it vests. After the option vests, Employee X exercises the option at a time when the stock underlying the option is worth $7. Therefore, at the time of exercise, Employee X incurs ordinary income of $2 (*i.e.*, $7 minus $5). Employee X holds the stock for more than one year following exercise of the option and then sells the stock when the stock is worth $11. Therefore, at the time of sale, Employee X incurs long-term capital gain of $4 (*i.e.*, $11 minus $7). If Employee X sold the stock within a year of exercising the option when the stock was worth, say $8, Employee X would have incurred short-term capital gain of $1 (*i.e.*, $8 minus $7).

In the case of a qualified stock option, if certain requirements are satisfied,[4] the option holder does not incur any tax until the underlying stock is sold. When the underlying stock is sold, the option holder recognizes long-term capital gain equal to the difference in the sales price of the stock and the exercise price. In other words, the full appreciation in the value of the stock from the date of grant to the date the stock is sold is taxed as long term capital gain.[5] For a variety of reasons, including the numerous requirements applicable to qualified stock options, most private companies only issue nonqualified stock options.

Section 409A

In large measure, the difficulty with stock options stems from the myriad of laws and regulations that must be considered when creating a stock option plan. One example is Section 409A of the Internal Revenue Code. In order for stock options to work properly, they must be structured to be exempt from Section 409A.[6] There are numerous requirements that must be satisfied in order for a stock option to be exempt from Section 409A.[7] With respect to nonqualified stock options, one requirement is that the exercise price must not be less than the fair market value of the underlying stock on the date of grant.[8] For nonpublic companies, determining fair market value can be an onerous task.

In order to value its stock, nonpublic companies need to use a "reasonable" application of a "reasonable" valuation method.[9] Whether a valuation method is "reasonable" depends on the surrounding facts and circumstances, but at the very least should consider the following factors:

1. The value of the company's tangible and intangible assets;

2. The present value of the company's anticipated future cash flows;

3. The market value of stock of similar companies;

4. Recent arm's length transactions involving the company's stock; and

5. Other relevant factors such as (a) valuation premiums and discounts, and (b) whether the valuation method is used for other purposes.[10]

Moreover, the valuation of stock is not reasonable if it is more than 12 months old or does not take into account any material recent developments regarding the issuer.[11]

Three safe-harbor valuations methods are presumed to be "reasonable." The first safe harbor is a valuation performed by an independent third-party appraiser.[12] Such appraisals, however, can be costly. The second safe harbor is the use of a fair market value valuation formula, which may only be used if several restrictive conditions are met.[13] One such restriction is that if an employee wants to sell the company stock, then he or she must offer to sell only at the formula value. Under the final safe harbor, an appraisal of the stock also is required and must take into account the five factors discussed above.[14] However, the person performing the appraisal need not be independent of the company (but does need to have at least 5 years of experience in business valuation or a similar field). This final safe harbor is only available to companies that have been in business 10 years or less.

In order to be exempt from Section 409A, a stock option also must satisfy the following additional requirements:

1. The stock underlying the option must be "service recipient stock" (generally, common stock of the company for which the option holder provides services to or its parent);

2. The number of shares subject to the option must be fixed on the grant date;

3. The transfer or exercise of the option must be subject to taxation under Section 83 of the Internal Revenue Code (this requirement is typically met); and

4. The option does not include any feature for the deferral of compensation other than the deferral or recognition of income until the later of (a) the exercise or disposition of the option, or (b) the time the stock acquired by exercising the option becomes substantially vested.[15]

Securities Law

Stock options also are subject to securities laws, which add to their complexity. As a general matter, all securities offered in the United States must be registered with the SEC or must qualify for an exemption from the registration requirements. Stock options offered by a private

company are not registered, so they must qualify for an exemption. The most common exemption used by private companies is Rule 701.[16]

Rule 701 allows private companies to grant equity awards pursuant to a written compensatory benefit plan, such as a stock option plan. Stock options may be granted to the issuing company's employees, directors, officers, consultants and advisors.

Under Rule 701, a company does not have any federal filing requirements and no federal filing fees need to be paid. There are, however, important conditions and requirements that must be satisfied in order to use Rule 701.

One requirement of Rule 701 is that the company issuing the options must provide to participants a copy of the plan as well as their option agreement. Further, if the amount of options issued in any 12-month period is greater than $5 million (measured by exercise price), the company must provide additional disclosure, including a summary of the stock option plan, risk factors associated with the stock underlying the options, and detailed company financial statements.

Another requirement under Rule 701 is that the total amount of options granted in any 12-month period (measured by exercise price) cannot be greater than:

- $1 million; or
- 15 percent of the issuing company's total assets (measured by the company's most recent annual balance sheet date); or
- 15 percent of the outstanding amount of the class of securities being issued under the stock option plan.

In addition, there are special requirements when issuing stock options to consultants and advisors under Rule 701. Specifically, stock options may be issued to "consultants and advisors" only if they (i) are natural persons, (ii) provide "bona fide services" to the issuing company, and (iii) the services are not in connection with any offer or sale of securities in a capital-raising transaction.

Phantom Equity Arrangements

Phantom equity arrangements are subject to much less regulation than real equity awards and, therefore, are much more flexible. As explained below, about the only legal requirement that needs to be addressed when designing a phantom equity arrangement is Section 409A of the Code. Phantom equity awards are also favorable from a tax perspective as well as a cash flow perspective, *i.e.*, the employee will never have to pay an exercise price because phantom equity awards are never actually exercised. Finally, the recipient of a phantom equity award, unlike

a holder of real equity, does not have the right to review the books and records of the issuing company.

What does a phantom equity arrangement look like? A phantom equity arrangement can be designed to mirror any type of real equity award and can provide any type of short or long-term incentive. In its simplest form, a phantom equity award entitles an employee to a percentage of the net sales proceeds that the owners of the company realize when the company is sold. For example, if an employee is granted a phantom equity award entitling him or her to one percent of the net sales proceeds and the company is sold for $10 million, the employee would be entitled to $100,000.

A phantom equity award also can be structured to mirror a stock option, such that it entitles an employee to a percentage of the appreciation in the value of the company, measured from the date the phantom equity award is granted to the date the company is sold. For example, if an employee is granted a phantom equity award entitling him or her to one percent of the appreciation in the value of the company, and the company is assigned a value of $4 million when the award is granted and the company is later sold for $10 million, the employee would be entitled to $60,000. Phantom equity awards also can be structured to pay annual incentives, such as a percentage of an annual profit distribution in the case of a limited liability company.

Tax Treatment of Phantom Equity

One of the benefits of a phantom equity award is that the recipient of an award that provides a sale event payment virtually never incurs a tax until the company sold. Thus, there is no tax when the award is granted, there is no tax when the award vests, and there is no tax when the award is exercised (because the award is never actually exercised). The only time the recipient of a phantom equity award is taxed is when the recipient is paid his award, *i.e.*, when the company is sold. If the company is never sold, then the recipient will never pay a tax. When the company is sold, the payment made to the award recipient is treated as ordinary income, subject to ordinary income tax rates as well as withholding. The one minor exception to the foregoing is that annual distributions made under a phantom equity arrangement are taxable in the year distributed.

Section 409A

When designing a phantom equity arrangement, one must be careful to structure the arrangement to be exempt from, or compliant with, Section 409A of the Internal Revenue Code. Failure to be exempt from, or comply with, Section 409A will result in penalties to the employee, including an additional 20 percent tax on the amount involved.[17]

Generally, an award will be exempt from Section 409A under the so-called "short-term deferral rule" if it is paid no later than March 15th of the year following the year in which the award vests (*i.e.*, is no longer subject to a substantial risk of forfeiture).[18]

Typically, in order to satisfy the short-term deferral rule, a phantom equity arrangement will condition payment of an award on the employee remaining employed by the issuing company through the date of payment. In effect, this causes the award to vest on the date of payment and, therefore, satisfy the short-term deferral rule. If an arrangement is not exempt from Section 409A, then it must comply with Section 409A. Generally, in order to comply with Section 409A, a phantom equity arrangement will specify that the award will be paid upon a "change in control" of the issuing company, as defined under Section 409A. Under Section 409A, a change in control occurs if there is a "change in ownership" of the company, a "change in effective control" of the company, or a change in ownership of a "substantial portion of the assets."[19]

A change in ownership of a company occurs when one person or a group acquires stock (or other ownership interest) that, combined with stock (or other ownership interest) previously owned, controls more than 50 percent (or such greater amount specified by the phantom equity arrangement) of the value or voting power of the company.[20]

A change in effective control occurs on the date that, during any 12-month period, either (x) any person or group acquires stock (or other ownership interest) possessing 30 percent (or such greater amount specified by the phantom equity arrangement) of the voting power of the company, or (y) the majority of the board is replaced by persons whose appointment or election is not endorsed by a majority of the board.[21]

A change in ownership of a substantial portion of the assets occurs on the date that a person or a group acquires, during any 12-month period, assets of the company having a total gross fair market value equal to 40 percent (or such greater amount specified in the phantom equity arrangement) of the total gross fair market value of all of the company's assets.[22]

Securities Law

Phantom equity arrangements are generally not subject to securities laws.

Drafting a Phantom Equity Arrangement

Any company that wishes to establish a phantom equity arrangement should consult with an experienced executive compensation lawyer. The lawyer will analyze the company's goals, recommend a design, and draft the applicable documents. He or she will also review other

features that could be added to the phantom equity arrangement, such as protective covenants. Protective covenants may include an agreement by the employee not to compete with his employer, not to solicit clients of his employer, not to solicit other employees of the employer, not to disclose confidential information of the employer, and not to disparage the employer. The arrangement also can impose other duties on the executive, *e.g.*, such as an obligation to provide notice before he or she resigns from employment.

Conclusion

Nonpublic companies are always looking for new ways to attract, retain, and reward their key executives. In most cases, these companies will want to consider a phantom equity arrangement. From a practical perspective, a phantom equity arrangement provides all of the benefits of real equity, but is subject to far less regulation and, therefore, can be tailored to fit the company's needs more easily. Phantom equity also has advantages from a tax and cash flow perspective for both the employee and the company. Finally, unlike real equity, a recipient of phantom equity does not have the right to review the books and records of the issuing company.

Notes

1. *See, e.g.,* Del. Code § 220(b); NY BSC Law § 624(b); Cal. Com. Code § 1601.

2. Section 83 of the Internal Revenue Code of 1986, as amended (Code).

3. Code § 1001(a).

4. To be "qualified," a stock option must satisfy numerous requirements, *e.g.*, the optionee must be an employee, the plan must designate the number of shares that may be issued as qualified stock options, and the plan cannot have a duration that exceeds 10 years. Code § 422.

5. In order to incur this favorable tax treatment, the underlying stock must not be sold within one year of date of exercise and two years of date of grant. Code § 422(a)(1).

6. A stock option that is exempt from Section 409A may be exercised at any time after vesting. A stock option that is not exempt from Section 409A may be exercised only at specific times permitted by Section 409A. Thus, much of the "optionality" of the stock option is destroyed if it is not exempt from Section 409A.

7. To be exempt from Section 409A, nonqualified stock options must satisfy the requirements set forth under Treas. Reg. § 1.409A-1(a)(5)(i)(A). Generally, qualified stock options meeting the requirements of Section 422 of the Code are exempt automatically from Section 409A. *See* Treas. Reg. § 1.409A-1(a)(5)(ii).

8. Treas. Reg. § 1.409A-1(a)(5)(i)(A)(1).

9. Treas. Reg. § 1.409A-1(a)(5)(iv)(B)(1).

10. *Id.*

11. *Id.*

12. Treas. Reg. § 1.409A-1(a)(5)(iv)(B)(2)(i).

13. Treas. Reg. § 1.409A-1(a)(5)(iv)(B)(2)(ii).

14. Treas. Reg. § 1.409A-1(a)(5)(iv)(B)(2)(iii).

15. Treas. Reg. § 1.409A-1(a)(5)(i)(A).

16. 17 C.F.R. § 230.701.

17. Code § 409A(a)(1)(B)(i)(II).

18. Treas. Reg. § 1.409A-1(a)(4).

19. Treas. Reg. § 1.409A-3(i)(5).

20. Treas. Reg. § 1.409A-3(i)(5)(v).

21. Treas. Reg. § 1.409A-3(i)(5)(vi).

22. Treas. Reg. § 1.409A-3(i)(5)(vii).