



**Annual Advanced Labor and Employment Law Symposium
2A - Awarding Employees “Almost” Equity: Phantom
Stock/Equity Equivalent Agreements; Options; Deferred
Compensation
(ELE230330-2A)**

Thursday, March 30, 2023

11:40 a.m. to 12:55 p.m.

Grassy Hill Country Club

Orange, CT

CT Bar Institute, Inc.

CT: 1.25 CLE Credits (General)

NY: 1.5 CLE Credits (AOP)

Table of Contents

Lawyers’ Principles of Professionalism..... 3

Faculty Biographies 6

Agenda..... 9

Awarding Employees “Almost” Equity: Phantom Stock/Equity Equivalent Agreements; Options; Deferred Compensation - Materials..... 10

LAWYERS' PRINCIPLES OF PROFESSIONALISM

As a lawyer, I have dedicated myself to making our system of justice work fairly and efficiently for all. I am an officer of this Court and recognize the obligation I have to advance the rule of law and preserve and foster the integrity of the legal system. To this end, I commit myself not only to observe the Connecticut Rules of Professional Conduct, but also conduct myself in accordance with the following Principles of Professionalism when dealing with my clients, opposing parties, fellow counsel, self-represented parties, the Courts, and the general public.

Civility:

Civility and courtesy are the hallmarks of professionalism. As such,

- I will be courteous, polite, respectful, and civil, both in oral and in written communications;
- I will refrain from using litigation or any other legal procedure to harass an opposing party;
- I will not impute improper motives to my adversary unless clearly justified by the facts and essential to resolution of the issue;
- I will treat the representation of a client as the client's transaction or dispute and not as a dispute with my adversary;
- I will respond to all communications timely and respectfully and allow my adversary a reasonable time to respond;
- I will avoid making groundless objections in the discovery process and work cooperatively to resolve those that are asserted with merit;
- I will agree to reasonable requests for extensions of time and for waiver of procedural formalities when the legitimate interests of my client will not be adversely affected;
- I will try to consult with my adversary before scheduling depositions, meetings, or hearings, and I will cooperate with her when schedule changes are requested;
- When scheduled meetings, hearings, or depositions have to be canceled, I will notify my adversary and, if appropriate, the Court (or other tribunal) as early as possible and enlist their involvement in rescheduling; and
- I will not serve motions and pleadings at such time or in such manner as will unfairly limit the other party's opportunity to respond.

Honesty:

Honesty and truthfulness are critical to the integrity of the legal profession – they are core values that must be observed at all times and they go hand in hand with my fiduciary duty. As such,

- I will not knowingly make untrue statements of fact or of law to my client, adversary or the Court;
- I will honor my word;
- I will not maintain or assist in maintaining any cause of action or advancing any position that is false or unlawful;

- I will withdraw voluntarily claims, defenses, or arguments when it becomes apparent that they do not have merit or are superfluous;
- I will not file frivolous motions or advance frivolous positions;
- When engaged in a transaction, I will make sure all involved are aware of changes I make to documents and not conceal changes.

Competency:

Having the necessary ability, knowledge, and skill to effectively advise and advocate for a client's interests is critical to the lawyer's function in their community. As such,

- I will keep myself current in the areas in which I practice, and, will associate with, or refer my client to, counsel knowledgeable in another field of practice when necessary;
- I will maintain proficiency in those technological advances that are necessary for me to competently represent my clients.
- I will seek mentoring and guidance throughout my career in order to ensure that I act with diligence and competency.

Responsibility:

I recognize that my client's interests and the administration of justice in general are best served when I work responsibly, effectively, and cooperatively with those with whom I interact. As such,

- Before dates for hearings or trials are set, or if that is not feasible, immediately after such dates have been set, I will attempt to verify the availability of key participants and witnesses so that I can promptly notify the Court (or other tribunal) and my adversary of any likely problem;
- I will make every effort to agree with my adversary, as early as possible, on a voluntary exchange of information and on a plan for discovery;
- I will attempt to resolve, by agreement, my objections to matters contained in my opponent's pleadings and discovery requests;
- I will be punctual in attending Court hearings, conferences, meetings, and depositions;
- I will refrain from excessive and abusive discovery, and I will comply with all reasonable discovery requests;
- In civil matters, I will stipulate to facts as to which there is no genuine dispute;
- I will refrain from causing unreasonable delays;
- Where consistent with my client's interests, I will communicate with my adversary in an effort to avoid needless controversial litigation and to resolve litigation that has actually commenced;
- While I must consider my client's decision concerning the objectives of the representation, I nevertheless will counsel my client that a willingness to initiate or engage in settlement discussions is consistent with zealous and effective representation.

Mentoring:

I owe a duty to the legal profession to counsel less experienced lawyers on the practice of the law and these Principles, and to seek mentoring myself. As such:

- I will exemplify through my behavior and teach through my words the importance of collegiality and ethical and civil behavior;
- I will emphasize the importance of providing clients with a high standard of representation through competency and the exercise of sound judgment;
- I will stress the role of our profession as a public service, to building and fostering the rule of law;
- I will welcome requests for guidance and advice.

Honor:

I recognize the honor of the legal profession and will always act in a manner consistent with the respect, courtesy, and weight that it deserves. As such,

- I will be guided by what is best for my client and the interests of justice, not what advances my own financial interests;
- I will be a vigorous and zealous advocate on behalf of my client, but I recognize that, as an officer of the Court, excessive zeal may be detrimental to the interests of a properly functioning system of justice;
- I will remember that, in addition to commitment to my client's cause, my responsibilities as a lawyer include a devotion to the public good;
- I will, as a member of a self-regulating profession, report violations of the Rules of Professional Conduct as required by those rules;
- I will protect the image of the legal profession in my daily activities and in the ways I communicate with the public;
- I will be mindful that the law is a learned profession and that among its desirable goals are devotion to public service, improvement of administration of justice, and the contribution of uncompensated time and civic influence on behalf of those persons who cannot afford adequate legal assistance; and
- I will support and advocate for fair and equal treatment under the law for all persons, regardless of race, color, ancestry, sex, pregnancy, religion, national origin, ethnicity, disability, status as a veteran, age, gender identity, gender expression or marital status, sexual orientation, or creed and will always conduct myself in such a way as to promote equality and justice for all.

Nothing in these Principles shall supersede, supplement, or in any way amend the Rules of Professional Conduct, alter existing standards of conduct against which a lawyer's conduct might be judged, or become a basis for the imposition of any civil, criminal, or professional liability.

Faculty Biographies

Daniel B. Fitzgerald

Daniel B. Fitzgerald is a principal of Brody Wilkinson PC and a member of the firm's Business and Dispute Resolution Groups. His practice is primarily focused in the areas of employment law and outside general counsel services. Mr. Fitzgerald practiced exclusively as a litigator for the first five years of his career and now endeavors to apply his litigation experience to assess risk and proactively resolve problems for his employment and business clients.

In his employment practice, Mr. Fitzgerald focuses on counseling employers on all aspects of human resources and employment law and representing executive-level employees in contract and severance negotiations. Mr. Fitzgerald handles a wide range of employment matters, including executive compensation, non-solicitation and non-compete covenants, employment handbooks, hiring and discharge issues, workplace investigations and state and federal law compliance. In addition, he frequently assists clients in select employment litigation matters.

Mr. Fitzgerald also provides outside general counsel services to various business clients, including those in the sports, health and fitness, and manufacturing industries. In this role, he assists clients in connection with risk and litigation management, contracts and general business matters, trademark protection, and corporate governance and compliance.

Mr. Fitzgerald is an avid writer, having created and published, *Connecticut Sports Law*, a blog covering the intersection of sports and the law. He most recently published an article in *Primerus Paradigm* entitled "Today's Use of Social Media Blurs Lines with Non-Solicitation Covenants." Mr. Fitzgerald is a Martindale-Hubbell AV-rated attorney. He was recognized by "Connecticut Super Lawyers" as a "Rising Star" in the areas of Employment and Labor, Business/Corporate and Entertainment and Sports from 2009 to 2017. Mr. Fitzgerald is admitted to practice in Connecticut and the U.S. District Court, District of Connecticut. He is a member of the Connecticut Bar Association and is the former chair of its Sports and Entertainment Law Section. Prior to joining Brody Wilkinson, he practiced at the Connecticut-based law firm of Updike, Kelly & Spellacy, P.C.

Mr. Fitzgerald received his J.D. from the University of Connecticut School of Law in 2005, where he was an associate editor of the *Connecticut Insurance Law Journal*. He received his B.A., *cum laude*, from Fairfield University in 1999, where he currently remains involved by supporting the University's St. Robert Bellarmine Pre-Law Society.

David S. Rintoul

David S. Rintoul founded Rintoul Law, LLC in 2022 after practicing since 1986 in large and small law firms. He practices in Connecticut, New York State, and nationwide in his ERISA benefits practice. David is admitted to practice in state and federal courts in Connecticut and New York State. David has handled jury and court-side trials in state and Federal court and has argued cases before the United

States Circuit Court of Appeals for the Second Circuit and the Connecticut Supreme and Appellate Courts. He appears before the Connecticut Retirement Services Division Commission and Medical Examination Board, the Connecticut Commission on Human Rights and Opportunities, and the Department of Insurance. He has been class counsel in national and Connecticut class-action lawsuits.

David has worked with employees, executives, and entrepreneurs in negotiating and litigating employment, non-compete, incentive compensation, severance agreements and equity agreements for more than thirty-five years. He has represented employers in negotiating and litigating all types of employment agreement.

David has been recognized as a SuperLawyer in 2006 and from 2016 to date in the area of employee benefits. He is a past chair of the Labor & Employment Section of the Connecticut Bar Association.

David resides in Wilton, Connecticut with his wife, Wendy Kerner, who is a professional harpist. He is an avid amateur trombonist, and has played with Wilton Rocks for Food, the Civic Orchestra of New Haven (Principal), the Berkshire Jazz Band in Wilton, the American Chamber Orchestra in Fairfield, Troupers Light Opera Company in Darien, the Oddfellows Summer Children's Circus of Middletown, and other classical, jazz and rock groups around the state.

Ryan C. Shepard

Ryan Sheppard is a Partner with Rolleri & Sheppard CPAS, LLP. He has extensive experience in tax and business consulting for privately held companies, individuals, and not-for-profit organizations.

As a small business and individual tax expert Mr. Sheppard has extensive experience on issues surrounding taxation, compliance, and long term planning. Mr. Sheppard understands the tax code complexities surrounding individuals and small business and the integration between them.

For the privately held companies he represents, Mr. Sheppard is a seasoned business and tax advisor. His wide-ranging experience in business consulting, tax planning, accounting, acquisitions and sales allow him to provide these clients with well rounded, practical, and strategic forward thinking advice. Mr. Sheppard has assisted his clients with buyout strategies, mergers and acquisitions, sound tax advice, owner compensation matters, and cost reduction strategies.

Mr. Sheppard has testified in Court related to Federal and State tax law related to privately held companies and individuals. In addition he has been engaged to consult on dozens of legal related cases related to Federal tax law.

Mr. Sheppard is the Chairman of the Connecticut Society of Certified Public Accountant's Professional Ethics Committee. Mr. Sheppard was appointed as a member of the Connecticut Society of Certified Public Accountant's Advisory Council. He also serves on the Connecticut Society of Certified Public Accountant's Federal Income Taxation Committee and the Not for Profit Organizations Committee.

Some of Mr. Sheppard's more notable published work is as follows:

- IRS Allows SALT Tax Deduction Workaround...For Some - Bloomberg December 2021.
- Divorce and Tax Considerations - CPA Journal 2021.
- Advising Clients in a Post Covid World - Bloomberg 2020
- Partnership Abandonment- CPA Journal 2016.
- The Tax and Financial Implications of Divorce - CPA Journal 2013.

He has lectured at several continuing education seminars including the Connecticut Bar Association, The Connecticut Exit Planning Exchange, and a variety of accredited courses, primarily focusing on issues affecting privately held companies. In 2018 he presented a National Webinar on the Tax Cuts and Jobs Act of 2017.

Mr. Sheppard is a licensed CPA in New York and Connecticut. He is Certified in Financial Forensics (CFF). He is a member of the New York State Society of Certified Public Accountants and the Connecticut Society of Certified Public Accountants. Mr. Sheppard is a member of the American Institute of Certified Public Accountants. He is a graduate of Ball State University. Mr. Sheppard is a former member of the Greenwich, CT chapter of the National Association of Divorce Professionals (NADP).

Mr. Sheppard was appointed the 2012 & 2011 Co-Chair of the annual Not for Profit Organizations conference sponsored by the Connecticut State Society of Certified Public Accountants. He is the treasurer and sits on the board of Sphere Networking, LLC. He is the treasurer and a board member of Operation Hope, Inc. (a Fairfield based nonprofit organization). He was also the Chairman of the Board for Classes 4 Classes, Inc. (a national nonprofit organization). He is a three term treasurer (former) of Black Rock Congregational Church in Fairfield, CT and current treasurer of Masuk High School All Sports Booster Club.

Agenda

Session 2A: Awarding Employees “Almost” Equity: Phantom Stock/Equity Equivalent Agreements; Options; Deferred Compensation (ELE230330-2A)

Annual Advanced Labor and Employment Law Symposium

Grassy Hill Country Club, Orange

March 30, 2023

11:40 a.m. – 12:55 a.m.

Presenters:

Daniel B. Fitzgerald, Brody Wilkinson PC, Southport

David S. Rintoul, Rintoul Law LLC, Wilton

Ryan C. Sheppard, Roller & Sheppard CPAS LLP, Fairfield

11:45 a.m. – 11:50 a.m.	Introduction of Speakers and Topic
11:50 a.m. – 12:15 p.m.	General Considerations of Incentive Compensation Plans
12:15 p.m. – 12:40 p.m.	Phantom Stock, Deferred Compensation & Options
12:40 p.m. – 12:45 p.m.	Wrap Up
12:45 p.m. – 12:55 p.m.	Questions

**Awarding Employees “Almost” Equity:
Phantom Stock/Equity Equivalent Agreements; Options; Deferred Compensation**

Preliminary considerations

Daniel B. Fitzgerald
Brody Wilkinson PC
Southport, CT
dfitzgerald@brodywilk.com
(203) 319-7154

The following materials contain practical considerations for gathering the necessary information to advise clients in connection with phantom stock and equity arrangements. Particularly when dealing with closely held businesses, the client's objectives should drive the choice of equity or “almost” equity vehicles. Often times the choice of equity or “almost” equity vehicles has precedential effect (at least informally) within an organization, making the preliminary discussions of increased importance.

- Counseling the *Employer* client
 - o Understand the corporate structure
 - What type of entity does the business operate under?
 - What is the universe of governing documents? (i.e. operating agreement, shareholders agreement, articles of incorporation, articles of organization)
 - Who are the owners?
 - Is the business closely held?
 - o Understand the employment structure
 - How many employees are in place?
 - Who are the key employees?
 - How are the employees employed?
 - At-will / no employment agreement
 - At-will / with employment agreement
 - Employed for a term with employment agreement
 - Are the employees subject to restrictive covenants?
 - Are any equity or phantom equity plans in place?
 - o Understand the employer’s end goals
 - Retention of key employee or employees
 - Incentivize employees
 - Reward key employees
 - Prepare business for sale
 - o Incentive arrangements for consideration
 - Phantom stock/equity
 - PROS:
 - o Less complicated than actual equity

- No voting, member or shareholder rights (consider minority member/shareholder rights under Conn. Gen. Stat. § 34-255i and Conn. Gen. Stat. § 33-946)
 - Prevent dilution
 - Less expensive than actual equity
 - Incentivize, retain employees
 - Maximize flexibility
 - CONS:
 - Requires a cash payout
 - Not actual equity for the employee who wants to be an owner
 - Reward is based on company growth when employee may not have a direct impact on stock value
 - May be subject to ERISA or 409A
 - Actual equity
 - PROS:
 - Employee enjoys the privileges and responsibilities of ownership
 - Maximize incentive for employee
 - Employee directly benefits from company value to which employee contributes
 - CONS:
 - Complicated and expensive for employee
 - Dilution of ownership
 - Minority member/shareholder rights
 - Termination of employee becomes more complicated
 - Performance bonus
 - PROS:
 - Less complicated than virtually any other option
 - Easy for both sides to understand
 - Simple contractual clause or letter agreement
 - Only pay for achievement of performance goals
 - Employer retains some discretion
 - CONS:
 - Less commitment by employer
 - Less incentive for employee (perhaps)
 - Employee may not receive share of company value that employee helped create
- Counseling the *Employee* client
- Understand the employee's goals
 - Receive compensation for value added to business, loyalty
 - Capitalize on business sale or merger
 - Leverage status as key employee for financial gain
 - Identify the employee's needs
 - Cash vs. Equity

- Planning for sale or merger
- Deal with restrictive covenants if necessary or is possible (especially if sale or merger is expected)
- Understand the employee's leverage
 - Is the employee critical to the business?
 - What promises have been made?
 - Has employer presented a plan/agreement or is employee involved in discussions concerning structure of arrangement?

Types of Quasi Equity Incentive Compensation: Drafting and Regulatory Concerns

David S. Rintoul
 Rintoul Law, LLC
 Wilton, CT
dsr@rintoullaw.com
 (203) 349-8500

These materials will mainly discuss phantom stock, stock appreciation rights; and deferred compensation plans. There are many other types of equity and quasi equity, such as: incentive stock options; non-qualified stock options; restricted stock; restricted stock units; performance shares; performance share units. For a comprehensive discussion of all these types of plans, which are beyond the scope of these materials, see the Equity Compensation Awards Comparison Chart at the end of materials, which Thompson-Reuters has kindly given us the permission to use.

Regulatory Concerns

- Taxation: tax counsel for drafting and implementation of plans is crucial. Tax issues include:
 - 409A restrictions on terms of deferred compensation. Harsh consequences for employee if violate 409A; penalties for company for failure to report/withhold taxes (see Ryan Shepard's materials at page 9 of the materials);
 - To avoid 409A problems, generally have distributions only on specified date and fixed schedule; death, disability (Treas. Reg. §1.409A-3(i)(4)), change in control (Treas. Reg. §1.409A-3(i)(4)) or separation of service (Treas. Reg. §1.409A-3(i)(4)). Consulting/part-time employment can cause problems with the separation of service requirement.
 - For 409a, can only condition payment on employer's financial condition if payment will jeopardize ability of company to continue as a going concern, and payment is delayed until first year where payment would not be such a danger.
 - Having payment on an IPO can create 409A issues.
 - FICA taxes due on vesting of interest;

- Compliance with Section 280G excise tax on excessive payments on a change in control;
 - Accounting requirements for taking the company's accrued obligations under the agreement into account.
 - See chart at page 11 of the materials for a discussion of specific tax issues for each type of plan.
- ERISA Issues. Is the plan an ERISA plan subject to ERISA vesting, funding, reporting and disclosures rules? If so, state law claims will be preempted by ERISA and suit will be subject to removal to federal court.
- Deferred Comp/Quasi Equity: Can be an ERISA plan depending on a fact specific determination whether the plan requires an “on-going administrative scheme.” A one-person plan requiring a once-a-year calculation of appreciation of value of company that did not involve any discretionary decisions held not an on-going administrative scheme and so not an ERISA plan. Cantrell v. Briggs & Veselka Co., 728 F.3d 444, 451 (5th Cir. 2013).
 - Even if subject to ERISA, exempt from participation, vesting, funding, or fiduciary duties if it qualified as a “top-hat” plan 29 U.S.C. §1051(2). To qualify for the top hat ERISA exemption, the plan must be unfunded or funded with assets available to creditors, and must be to the benefit of a select group of management/highly compensated employees. Demery v. Extebank Deferred Compensation Plan (B), 216 F.3d 283, 287 (2d Cir. 2000).

Drafting Considerations for Phantom Stock, Other Quasi Equity

- Under What Circumstances is Payment Due: Front End (Cash from Operations) vs Back End (proceeds on sale of company/IPO)
- Front end participation: Share of current cash flow/profits.
 - Profits participation not usual: If it is a startup/early stage, other uses for any free cash;
 - If it is a compulsory formula (% of free cash flow) ties managements hands, may need profits for growth
 - If discretionary, may be an illusory promise.
 - More usual to have phantom interest holders paid if dividends/distributions to equity holders, but such payments rare in small companies/startups.
 - Back End participation: Payment on Sale/IPO
 - When payment due:
 - Sale of company;
 - Initial public offering;

- Value of company after a set number of years.
 - Method of calculating sale price if payout on sale or IPO:
 - purchase price less transaction costs (attorney’s fees, broker fees) times percentage interest.
 - Does employee get a share of post-closing payments (earnouts based on post-closing performance, disbursements of escrows)
 - Owner can divert sale proceeds through employment/consulting agreements.
 - If a future sale/IPO is not considered likely, can value interest after a certain period (three – ten years) and have the company valued and pay out interest at that time.
 - Value as
 - Issues of valuation of interest, discussed above: valuation or formula
 - Determined by company accountant binding on parties, or
 - Provide formula (multiplier of cash flow, earnings before taxes, depreciation and amortization “EBITDA”)
 - Having the employee retain an expert to value the company if disagreement with plan’s valuation difficult because the company would have to open its books.
 - Payment terms: cash up front; promissory note, security for note. Changing payment terms after award or having payment due on other than a date certain can create 409A issues.
 - 409A Issues: See Ryan Sheppard’s materials for a more extensive discussion of 409A. Important to consult tax counsel on any potential 409A issue.
- Vesting
- Common to have vesting over 3-5 period to encourage retention: shorter vesting, less likely to be covered by ERISA since looks less like a retirement plan
 - Immediate vesting on termination without cause, disability, death, corporate change of control
 - Lose vested interest if violate non-compete, or termination for cause. Non-payment under phantom stock due to violation of non-compete upheld in Friese v. Fadner Media Enterprises, LLC, Docket No. FSTCV146021437, 2017 Conn. Super. LEXIS 126 (Super. Jan. 18, 2017). Court will examine whether non-compete reasonable even if only consequence of violation is forfeiture of benefits under the agreement. Deming v. Nationwide Mutual Ins. Co., 279 Conn. 745, 768, 905 A.2d 623 (2006) (rejecting holdings in other states that a forfeiture clause is not a restraint of trade since the former employee may still work for a competitor at the cost of losing benefits under the agreement).
 - Clawback of payments if fraud, misconduct, violation of post-employment covenants, restatement of company finances resulting in an overpayment.

- Dilution:
 - Account for change in value of phantom stock if additional equity issued; provide for phantom stock to be diluted, or equity holders will be short changed.
 - Dilution in many cases won't hurt the participants, as they can benefit from added capital new investors bring in.

- Termination of employment:
 - Buyout of interest, not required:
 - Low option: book value (depreciated value of assets and accounts receivable) if voluntary leaving, term for cause
 - Full market value on termination for cause, death, disability. See above for discussion of valuation methods.

 - Usually terminate on end of employment, but can provide to pay out if sale within a year of end of employment.
 - Can provide for termination of interest on death, disability, or termination of employment for any reason.

- Disclaimers
 - No contract for term/for cause termination standard
 - No rights as shareholder
 - Non-transferable/no alienation
 - Forfeiture provisions
 - Tax withholding
 - Right to amend/cancel plan: plan can provide for cancellation of plan, even as to vested rights.
 - Release of employer from tax liability
 - 409A savings clause: that plan will be deemed amended as necessary to comply with 409A.

Stock Appreciation Rights

- Like phantom stock, but on gives an interest in increase in value of company from date of grant.
- See p. 3 of Equity Compensation Awards Comparison chart for a further discussion of issues regarding stock appreciation rights.

Non-Qualified Deferred Compensation

- Not address qualified deferred compensation plans, which are ERISA pension plans that must be available to all employees.
-
- Taxation of Non-qualified Accruals
 - No income tax on deferred compensation on accrual, but only when is paid.
 - FICA due when interest vests.

- Must be unsecured/unfunded:
 - Any assets must be available to creditors. Can establish a separate account but the employer must solely own the account.
 - Can have a rabbi trust, (a IRC 671 trust vehicle for accumulating assets to support an employers unfunded deferred compensation plan), where company funds a trust that is irrevocable, so the company can't change its mind, but assets are available to unsecured creditors. Strict requirements to qualify as a rabbi trust, which must also qualify under 409A. Revenue Procedure 92-64; IRC 671.
- Must comply with 409A: See Ryan Shepard FAQs

Qualified and Non-Qualified Stock Options.

- Options are the right to buy a company's shares for a certain price, called the strike price. The options have value when the value of the company exceeds the strike price.
- Qualified stock options must qualify for certain IRS requirements to obtain favorable tax treatment, while non-qualified plans do not and so have fewer tax benefits.
- See Ryan Sheppard's materials at page 8 of the materials for a detailed discussion of stock options and the 83(b) election allowing the employee the option to pay taxes on the value of the options at the time of grant rather than at time of exercise.

Other Types of Incentive Compensation

Discussions of other types of incentive compensation are beyond the scope of this presentation, but the Thompson-Reuters chart attached as a comprehensive discussion of the different types, and tax and business ramifications of each.

FAQ: Qualified and Non-Qualified Stock, 83(b) and §409A

Ryan C. Sheppard, CPA Partner
Rolleri & Sheppard CPAS, LLP Office:
(203) 259-2727
Rcs@rollerisheppardcpas.com

1. What is the difference between qualified and nonqualified options?

Many employee compensatory packages include stock options. There are two types of options to consider from a tax standpoint – qualified stock options (QSOs) and nonqualified stock options (NQSOs). QSOs are also commonly referred to as Incentive Stock Options (ISOs). Of these two options, QSOs must meet various IRS requirements to qualify for preferential tax treatment, while NQSOs do not.

QSOs must be held for two years after receiving the stock and one year after exercising the option. In addition, the QSOs are not transferrable and the employee must remain with the company from the date the QSO is received until three months before it is exercised. The above are not required to be met by NQSOs.

There is a “bargain” element for both these options which makes them an attractive noncash compensation options since the recipient is granted the right to exercise stock at a price lower than fair market value (FMV). For QSO, the “bargain” element is not recognized as income, rather, the difference between the exercise price and the sale price when disposed qualify it as a long-term capital gain. This is a big advantage as long-term capital gain tax rates are a lower preferential rate compared to the ordinary income tax rates. However, the “bargain” element for QSOs are included as income for Alternative Minimum Tax purposes. For NQSOs the “bargain” element is included in W-2 wages at the time of exercise, thus, only the appreciation over the FMV at exercise qualifies as a capital gain.

2. What is the 83(b) election and how does it work?

The 83(b) election is a provision that gives an employee or start up founders the option to pay taxes on the total fair market value of restricted stock at the time of granting (ordinarily it is subject to a vesting schedule, and income is recognized as ownership vests). This is beneficial in the event the value of the restricted stock appreciates in future years. If an employee is offered restricted stock or equity in the company, the employee can opt to file an 83(b) election, and recognize the FMV of stock as ordinary income at the time of grant, rather than when then the equity vests (often times at a higher price as stock may vest over several years). When the stock is ultimately sold, the employee qualifies for long-term (provided it was held over one year) capital gain rates on any further increase in value from date the election was made. If the election is executed properly, this acceleration of income recognition minimizes the amount recognized as compensation, and increases income subject to lower capital gain rates. It must be noted a properly executed election must be remitted to the IRS within 30 days of stock grant, with the requisite information (date transferred, # of shares, FMV, amount paid, if any, etc.) detailed.

For example, on January 15, 2023, Taxpayer A was granted 80,000 shares of company stock, subject to vesting over 3 years. Taxpayer A opts to file a timely Sec. 83(b) election on February 15, 2023. At this time, the fair market value of company stock was \$0.20 per share. As a result, the taxpayer must recognize \$16,000 (80,000 shares x \$0.20 per share) as compensation on their 2023 tax return. Both their employer and the IRS must be notified of their election within 30 days of grant.

Continuing the above example, Taxpayer A sells their shares of the stock on January 15, 2027, when the FMV of company stock is \$5.00 per share. They receive \$400,000 (80,000 shares x \$5.00 per share) in proceeds on sale, and must report a long term capital gain of \$384,000 (Proceeds less amount previously taxed as compensation). By making an 83(b) election in January of 2023, Taxpayer A has accelerated their capital gain holding period and maximized the amount taxable at a 15-20% rate, as opposed to their marginal rate, which may be as high as 37%.

An 83(b) election can be a powerful tax avoidance tool, provided the stock has a low value upon election and appreciates considerably prior to disposition.

3. What is IRC §409A and who is affected by it?

§409A applies to nonqualified deferred compensation and essentially governs the taxation of deferred compensation. It can apply to nonqualified retirement plans, elective deferrals of compensation, severance and separation programs, post-employment payments provided for in an employment agreement, stock options, other equity incentive programs, reimbursement arrangements and a variety of other items.

4. How do §409A plans work?

In a §409A plan, an employee defers the receipt of earned income to a future year, effectively reducing their tax burden. If the deferral constitutes wage income, there are special timing rules in relation to FICA tax. The deferral will be considered wages for FICA purposes on the later of the date when the services are performed or the date when the deferral amount is no longer subject to a substantial risk of forfeiture.

Additionally, §409A must meet requirements, both in writing and in operations. The amounts deferred are to be payable upon specific events outlined in the plan which also would include when it is payable. The plan also must outline that the employer nor employee can accelerate the payments. Lastly, the election to defer the compensation must be made prior to the beginning of the tax year in which the amounts will be earned.

5. What are the penalties under §409A and how do the penalties apply?

There are penalties for not following §409A rules. These penalties are assessed when there is a failure to make deferral or distribution elections in a timely manner. If found in violation of §409A rules, a 20% federal penalty on the deferred amounts as well as state penalties apply. Additionally, an underpayment penalty on the deferred income and late interest on the unpaid taxes apply.

6. What are the documentation requirements under §409A?

§409A requires that the plan needs to be in writing, the plan must state the value of compensation that will be deferred, when it will be paid, and how it will be paid. Deferred compensation can be paid when there is a separation of services, a date that the participant specifically chooses, disability, death, or change of control. Generally, the time of payment may not be earlier or delayed.

7. Are assets under §409A plans secured or unsecured?

Assets under §409A plans are treated as unsecured assets as it is a promise to pay a future benefit. These assets are not protected from creditors if an employer files for bankruptcy. Nonqualified deferred compensation is generally not protected and classified as an unsecured asset.

8. What is “phantom” stock?

Phantom stock is a type of deferred compensation that falls under §409A where an employee is awarded a unit that is measured by the value of a share of the company’s stock. It is not actual stock in the company and no equity ownership is awarded in this transaction. In other words, there are benefits of owning stock without actually owning the company stock. The deferred compensation associated with the phantom stock will be subject to tax when it is actually paid and received by the employee at ordinary income tax rates. Like other §409A plans, phantom stock is subject to FICA tax when the stock units vest.

Equity Compensation Awards Comparison Chart

by Practical Law Employee Benefits & Executive Compensation

Maintained • USA (National/Federal)

A Chart setting out a general description as well as the advantages, disadvantages, federal tax treatment, and accounting implications of certain types of equity compensation awards granted by employers to employees and other service providers. This Chart covers incentive stock options (ISOs), non-qualified stock options, restricted stock, restricted stock units (RSUs), stock appreciation rights (SARs), performance shares, performance units, and phantom stock.

This Chart compares the advantages, disadvantages, federal tax treatment, and accounting implications of certain types of equity compensation awards granted by employers to employees and other service providers. This Chart covers:

- **Incentive stock options** (ISOs).
- **Non-qualified stock options**.
- **Restricted stock**.
- **Restricted stock units** (RSUs).
- **Stock appreciation rights** (SARs).
- Performance shares.
- Performance units.
- Phantom stock.

This Chart does not address **profits interests**. For information on profits interests and other types of partnership equity compensation, see [Partnership Equity Compensation Toolkit](#).

For more information on the equity compensation awards addressed in this chart, see Practice Notes:

- [Equity Compensation Awards: Overview.](#)
- [Stock Options: Overview.](#)
- [Overview of the Taxation of Equity Compensation Awards.](#)
- [Choosing the Right Type of Equity Compensation for Startup Company Employees.](#)
- [Basic Accounting for Stock-Based Compensation Under FASB ASC Topic 718.](#)

Type of Award	General Description	Advantages	Disadvantages	Federal Tax Treatment	Accounting Implications
Incentive Stock Options (ISOs)	<p>Right to purchase employer stock at a set price.</p> <p>Must comply with Section 421 (26 U.S.C. §421) and Section 422 of the Internal Revenue Code (Code) (26 U.S.C. § 422) requirements for favorable tax treatment to apply.</p>	<p>Favorable tax treatment for employees.</p> <p>Good incentive for companies anticipating substantial growth.</p> <p>May be exercised at election of holder.</p>	<p>Holder must pay exercise price.</p> <p>No employer deduction on exercise.</p> <p>Complicated tax treatment and rigid requirements (such as a holding requirement).</p> <p>Cannot be granted to non-employees.</p> <p>Limited flexibility to amend due to tax and accounting restrictions.</p> <p>Limited incentive if stock price not increasing.</p>	<p>No tax on grant or vesting.</p> <p>No tax on exercise but spread is an adjustment for calculating alternative minimum tax (AMT).</p> <p>Employer is not entitled to a deduction on exercise unless a disqualifying disposition occurs.</p> <p>On sale, if the holding requirement is met, excess of sale proceeds over exercise price is taxed at capital gains rates.</p>	<p>Fair value (estimated using option pricing model) must be recognized as a compensation expense as of the grant date and amortized over the vesting period.</p>
Non-Qualified Stock Options (NQSOs)	<p>Right to purchase employer stock at a set price.</p>	<p>More flexibility than ISOs.</p>	<p>Employee must pay exercise price.</p>	<p>No tax at grant or vesting.</p> <p>Ordinary income recognized on</p>	<p>Fair value (estimated using option pricing model) must be recognized as</p>

	<p>Must have at least fair market value (FMV) exercise price to be exempt from Section 409A.</p>	<p>Employer entitled to deduction at exercise.</p> <p>Good incentive for companies anticipating substantial growth.</p> <p>Unlike ISOs, can be granted to non-employee directors, consultants, and other advisors.</p> <p>May be exercised at election of holder.</p>	<p>Limited incentive if stock price not increasing.</p>	<p>the spread at exercise (and corresponding employer deduction).</p> <p>At sale, capital gain or loss on the difference between the sale price and the sum of the exercise price paid plus the ordinary income recognized on exercise.</p> <p>Section 83(i) (26 U.S.C. §83(i)) allows certain private companies to offer qualified employees opportunity to defer income recognition on illiquid company stock acquired through exercise of NQSOs for up to 5 years. But onerous requirements are deterrent.</p>	<p>a compensation expense as of the grant date and amortized over the vesting period.</p>
<p>Stock Appreciation Rights (SARs)</p>	<p>Right to receive excess of FMV of shares at exercise over exercise price.</p> <p>Must have at least FMV exercise price to be exempt from Section 409A.</p> <p>Typically paid in cash.</p>	<p>Employer deduction at exercise.</p> <p>Good incentive for companies anticipating substantial growth.</p> <p>Unlike options, employee does not pay exercise price.</p>	<p>Limited incentive if stock price not increasing.</p> <p>Limited flexibility to amend due to tax and accounting restrictions.</p> <p>No capital gain treatment.</p>	<p>No tax at grant or vesting.</p> <p>Ordinary income recognized on the spread at exercise (and corresponding employer deduction).</p>	<p>Fair value must be recognized as a compensation expense and is accrued over the vesting period and periodically re-estimated and the liability adjusted until the SAR is paid.</p>

	Sometimes referred to as phantom equity.	May be exercised at election of holder.	Variable accounting.		
Restricted Stock	<p>Grant of actual shares of stock, but subject to forfeiture or repurchase until end of restricted period.</p> <p>Holder receives voting and dividend rights.</p>	<p>Holder is the beneficial owner of shares at grant, aligning interests with shareholders.</p> <p>Award retains some value even if stock price declines.</p> <p>Holder does not typically pay anything (or nominal amount) for award.</p> <p>For stock with little or no value on grant date, ability to make Section 83(b) election can offer substantial tax benefit.</p> <p>Not subject to Section 409A.</p>	<p>If 83(b) election is made and stock is forfeited, no refund of taxes paid.</p> <p>Holder must come up with money to pay tax at vesting (or grant if 83(b) election is made).</p> <p>Time-vesting restricted stock may be less incentivizing than performance shares.</p>	<p>Governed by Code Section 83 (26 U.S.C. § 83(b)).</p> <p>If no 83(b) election is made, no tax at grant.</p> <p>Ordinary income at vesting on excess of FMV at vesting over amount paid (if any).</p> <p>At sale, capital gain or loss on the difference between the sale price and the FMV of the stock at vesting.</p> <p>If 83(b) election is made, ordinary income on FMV at grant.</p> <p>Capital gain or loss on the difference between the sale price and the FMV of the stock at grant.</p> <p>Employer entitled to deduction corresponding to amount of ordinary income recognized by employee.</p>	<p>Fair value (typically based on FMV) must be reflected as a compensation expense as of the grant date and amortized over the vesting period.</p> <p>Dividends paid during the vesting period are generally not recognized as additional compensation cost.</p>

				Dividends paid on unvested shares are taxed at ordinary income rates.	
Restricted Stock Units (RSUs)	<p>Company's unfunded, unsecured promise to deliver shares of stock in the future. An RSU is equal in value to one share of company stock.</p> <p>For information on cash-settled RSUs, see Phantom Stock.</p>	<p>Award retains some value even if stock price declines.</p> <p>Holder does not pay anything for award.</p> <p>Company may offer ability to defer settlement, subject to Section 409A's requirements.</p>	<p>Holder are not beneficial owners – no voting or dividend rights (although company may grant dividend equivalents).</p> <p>Must be structured to comply with or be exempt from Section 409A.</p> <p>Time-vesting RSUs may be less incentivizing than PSUs.</p>	<p>No tax at grant or vesting if complies with or is exempt from Section 409A.</p> <p>FMV of RSU subject to FICA and FUTA at vesting.</p> <p>Ordinary income recognized at settlement (employer entitled to corresponding deduction).</p> <p>At sale, capital gain or loss on the excess of the sale proceeds over the FMV of the shares at settlement.</p> <p>Dividend equivalents are taxed at ordinary income rates.</p> <p>Section 83(i) (26 U.S.C. §83(i)) allows certain private companies to offer qualified employees opportunity to defer income recognition on illiquid company stock acquired through settlement</p>	<p>Grant date fair value (typically based on FMV) must be reflected as a compensation expense as of the grant date and amortized over the vesting period.</p> <p>Dividend equivalents paid during vesting period are typically not recognized as additional compensation cost.</p>

				of RSUs for up to 5 years. But onerous requirements are deterrent.	
Performance Shares	<p>Award of target number of shares which are held in escrow until they vest.</p> <p>The number of shares earned depends on performance against applicable performance criteria during the performance period (often three years).</p> <p>Value of ultimate award depends on number of shares earned (often it is possible to earn between 0% to 200% of target number of shares) and stock price.</p>	<p>Incentivize and reward specific performance criteria.</p> <p>Performance awards are favored by shareholders and shareholder advisory groups.</p> <p>Holder does not pay anything for award.</p>	<p>Less retentive effect if it becomes likely during performance period that goals will not be achieved.</p> <p>Administrative complexity in determining whether performance goals have been achieved.</p>	<p>No tax at grant.</p> <p>Ordinary income recognized on FMV at vesting (employer entitled to corresponding deduction).</p> <p>At sale, capital gain or loss on the difference between the sale price and the FMV of stock at vesting.</p>	<p>Grant date fair value (based on FMV of expected number of shares to be earned (typically target)) must be reflected as a compensation expense as of the grant date and amortized over the vesting period.</p>
Performance Share Units (PSUs)	<p>Company's unfunded, unsecured promise to award a target number of shares (or cash equivalent) in the future if performance targets are achieved during the performance period (often three years).</p>	<p>Incentivize and reward specific performance criteria.</p> <p>Performance awards are favored by shareholders and shareholder advisory groups.</p> <p>Holder does not pay anything for award.</p>	<p>Holders are not beneficial owners – no voting or dividend rights (although company may grant dividend equivalents).</p> <p>Must be structured to comply with or be exempt from Section 409A.</p> <p>Administrative complexity in</p>	<p>No tax at grant or vesting if complies with or is exempt from Section 409A.</p> <p>FMV of PSU subject to FICA and FUTA at vesting.</p> <p>Ordinary income recognized at settlement (employer entitled</p>	<p>Grant date fair value (based on FMV of expected number of shares to be earned (typically target)) must be reflected as a compensation expense as of the grant date and amortized over the vesting period.</p>

	<p>A PSU is equal in value to one share of company stock.</p> <p>For information on cash-settled PSUs, see Phantom Stock.</p>		<p>determining whether performance goals have been achieved.</p>	<p>to corresponding deduction).</p> <p>At sale, capital gain or loss on the excess of the sale proceeds over the FMV of the shares at settlement.</p>	
<p>Phantom Stock or Phantom Stock Units</p>	<p>Company's unfunded, unsecured promise to pay the value of shares of stock, typically in cash, in the future.</p> <p>Designed to replicate company stock without giving away actual stock.</p> <p>Vesting can be tied to service or company performance, or both.</p>	<p>Preferred by private companies that want to share economic value of company with key talent without giving away actual equity.</p> <p>Flexibility to design in various ways, including bonus plan, deferred compensation plan, or sale plan.</p>	<p>Difficult to understand.</p> <p>Holder are not beneficial owners – no voting or dividend rights (although company may grant dividend equivalents).</p> <p>Must be structured to comply with or be exempt from Section 409A.</p> <p>Company must have liquidity to pay cash when due.</p> <p>No capital gain treatment.</p> <p>Variable accounting.</p>	<p>No tax at grant or vesting if complies with or is exempt from Section 409A.</p> <p>Subject to FICA and FUTA at vesting.</p> <p>Ordinary income recognized at settlement (employer entitled to corresponding deduction).</p> <p>Dividend equivalents are taxed at ordinary income rates.</p>	<p>Fair value must be reflected as a compensation expense as of the grant date and is re-measured at the end of each reporting period until settlement.</p> <p>Dividend equivalents paid during vesting period are typically not recognized as additional compensation cost.</p>