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EMPLOYEE INCENTIVE COMPENSATION PLANS: WHICH STRUCTURE IS BEST FOR YOUR BUSINESS?

(Employment Advisory No. 1)

Choosing the appropriate instrument to properly attract and retain key employees with incentives is critical to the successful growth and operations of your business. This Advisory is intended to briefly summarize some of the more popular instruments employed by companies and help you consider factors in determining the best type of structure for your business. Each company's situation is unique and the options set forth below may not be suitable for everyone, or you may be best served by creating a hybrid of one or more plans.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the distribution of this Advisory.

Instrument	Description	Up-Front Cost to Employee	Tax Consequences to Employee	Tax Consequences to Employer	Administrative Restrictions	Pros/Cons	Additional Comments

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Incentive Stock Options or ISO (aka Qualified Stock Options or Statutory Stock Options)	An option to purchase company stock at a specified price for a specified period of time that qualifies for favorable tax treatment under IRS Code Section 422.	Employee pays cash to exercise options.	Taxed when stock is sold. Eligible for capital gains treatment if stock is disposed of after statutory holding period. If sold before end of holding period ("disqualifying disposition,") employee forced to recognize ordinary income and capital gain.	Employer cannot deduct income declared as capital gains. Employer can deduct income declared as ordinary in a year of a "disqualifying disposition." Employer does not have to withhold payroll taxes.	IRS Code Section 422, including: (1) options may be granted only to company employees; (2) option plan must be approved by shareholders; and (3) option price cannot be less than FMV of stock at time of grant. Not subject to ERISA.	*Pros*: Favorable tax treatment for employees. Most commonly used option. *Cons*: Cash required to exercise option. Some risk to employees due to statutory holding period. Cannot be used for contract employees or board members. Less favorable tax treatment for employers.	Incentive Stock Option Plans can be discriminatory (i.e. they do not have to be offered on the same terms to all employees). Cash-less exercise may be allowed in the plan, or employers can provide Stock Appreciation Rights (SARs), to assist low-income employees in this purchase.

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Non-Qualified Stock Options or NSOs (aka Non-Statutory Stock Options)	A stock option that does not qualify for favorable tax treatment under IRS Code Sections 422 or 423.	Employee pays cash to exercise options and for taxes on the phantom gain at the time of exercise.	When option is exercised, employee recognizes ordinary income subject to applicable taxes (unless the option has an ascertainable FMV at the time of issue). Stock eligible for capital gains treatment when sold.	The employer receives a tax deduction for the amount of ordinary income recognized by the employee. Employer withholds income taxes and payroll taxes.	Not subject to ERISA.	*Pros*: Greater flexibility for employers with respect to plan design, ability to offer option price at less than FMV. Can be used for contract employees or board members. Employer can deduct ordinary income recognized. *Cons*: Cash required to exercise option. Reduced tax benefits for employees.	Cash-less exercise may be allowed in the plan, or employers can provide Stock Appreciation Rights (SARs), to assist low-income employees in this purchase.

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Employee Stock Purchase Plans (ESPP)	A plan under which a company allows employees to purchase stock at up to a 15% discount. Provides favorable tax treatment under IRS Code Section 423.	Employees pay cash to purchase stock; usually managed through direct payroll deductions.	Tax benefit received on payroll deduction. Income taxed when stock is sold. Eligible for capital gains treatment if held through statutory holding period. Employee recognizes ordinary income if exercise price was less than FMV at time of issue or if sold before end of statutory holding period.	Employer cannot deduct income declared as capital gains. Employer can deduct income declared as ordinary in a year of a disqualifying disposition. In the case of a disqualifying disposition, the employer will have to withhold income tax and payroll taxes.	IRS Code Section 423 applies, including: (1) options can only be granted to company employees; (2) plan must be approved by shareholders; and (3) options must be granted to all full-time employees with more than 2 years history. Not subject to ERISA.	*Pros*: Favorable tax treatment for employees. Flexibility on option pricing. *Cons*: Cash required to purchase stock. Statutory holding period applies.	Usually used in public companies. Regulations mandate that options be awarded to all, not just upper-management. The discounted price built into most ESPPs means that employees may be able to profit even if the stock price has gone down since the grant date.

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Phantom Stock	A right to receive a cash bonus equal to either the value of a specified amount of company stock or the increase in that value over a period of time.	There is no cost to the employee. Employee account is credited with stock "units" instead of actual stock. Upon trigger event (ie: termination of employment), the employee receives cash bonus equal to the stock value or increase in value since time of award.	Cash bonus is taxed as ordinary income at the time it is received.	Employer receives a tax deduction for the amount of ordinary income recognized by the employee. Employer withholds income taxes and payroll taxes.Employer must recognize compensation expense as the value of the award increases.	Companies have to be careful they do not inadvertently create a de facto ERISA plan. In order to avoid being subject to ERISA regs, phantom stock should apply only to select employees (such as designated non-management employees)), and should not allow deferral of payments.	*Pros*: No cash outlay required by employee. Can provide employees with advantage of stock ownership and dividends without dilution of actual company ownership.*Cons*: Avoidance of ERISA regs can limit impact of plan. No favorable tax treatment for employees. Company must have cash to pay out phantom options at time of liquidity event.	Primarily used in companies that want to share the economic value of equity, but not equity itself.

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Stock Appreciation Rights (SARs)	A right to receive, either in cash, employer stock, or a combination of the two, the appreciation in the value of a specified amount of employer stock over a certain period of time.	There is no cost to the employee. SARs can usually be exercised any time after they vest.	Upon exercise of the SAR, the cash or value of the stock will be taxed as ordinary income.	Employer receives a deduction upon exercise of the SAR equal to the amount of ordinary income recognized by the employee. Employer must recognize compensation expense as the value of the award increases.	Companies have to be careful they do not inadvertently create a de facto ERISA plan. In order to avoid being subject to ERISA regs, SARs should apply only to select employees (such as designated non-management employees), and should not allow deferral of payments.	*Pros:* No cash outlay from employees. Potential to avoid dilution of equity ownership if paid in cash. Alternatively, ability to pay bonus in stock if cash is not available. *Cons:* No favorable tax treatment for employees. Company must have cash to pay out phantom options at time of liquidity event.	Primarily used in companies that want to share the economic value of equity, but not equity itself. Often seen in small, family-owned companies as long-term incentive for key non-family executives.

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Restricted Stock Awards	A grant of company stock in which the recipient's rights to the stock are restricted until the shares "vest."	Stock awarded to employees at no cost; employee can pay cash for taxes on the stock immediately upon award.	If employee pays taxes on the stock as the stock vests, all income is ordinary income. If employee pays tax on all of the stock at the time of issue, any increase in the value of the stock will be taxed at the capital gains rate. If the employee forfeits the stock before it vests, any taxes paid produce a capital loss.	The employer receives a deduction for any ordinary income recognized by the employee.	Employee's rights to sell or transfer shares are restricted for a period of time. Vesting requirements can be based on length of service or level of performance. Not exempt from the definition of regular rate of pay under the FLSA.	*Pros:* Restricted stock has inherent underlying value (in contrast to options, where value = price appreciation only). Employee receives dividends and voting rights. Alignment employee incentives with company's long-term success.Cons: Substantial risk of forfeiture to employee.	Current trend towards restricted stock instead of options due to regulatory change requiring options expense. Can be used to reward long-term employees who took early risk in addition to traditional options. Restricted stock units provide favorable tax treatment for international employees. In general, restricted stock is usually awarded to higher-level employees.

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Non-Employer Stock Options	An option to purchase the stock of a company other than the employer.	Employee pays cash to exercise option and pay taxes on the phantom gain at time of exercise.	When option is exercised, employee recognizes ordinary income subject to applicable taxes (unless the option has an ascertainable FMV at the time of issue). Stock eligible for capital gains treatment when sold.	Employer receives a tax deduction for the amount of ordinary income recognized by the employee; the employer withholds income taxes and payroll taxes (same as non-qualified stock options)	Employer must purchase the stock on which the options are being granted. Granting options under a non-employer SOP usually results in an annual charge to earnings, as compensation expense increases in line with stock appreciation.	*Pros:* If company stock has slow growth, provides additional opportunity for employee incentivization. *Con:* Can be expensive, difficult to manage as employer.	For private companies, provides employees with stock that can be sold on the market as opposed to stock in their privately held employer.

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Employee Stock Ownership Plans (ESOPs)	A defined contribution employee benefit plan in which a trust is created to buy and hold company stock. Shares of the trust are then allocated to individual employee accounts.	In almost every case, ESOPs are a contribution to the employee, not an employee purchase.The average ESOP contribution is 6%-10% of pay.	Employees pay tax only on distributions, which are taxed as ordinary income. Distributions are not taxed if rolled into an IRA or a successor plan. If distribution occurs when employee is under 59 1/2 years (55 if terminated), the employee pays an additional 10% excise tax. Dividends allocated to an employee's ESOP account are taxed at the time of allocation as ordinary income but are not subject to excise tax.	Contributions up to 25% of the covered payroll are generally tax deductible to the company (can deduct the full value of contributed stock). A corporation that repays an ESOP loan gets to deduct principal as well as interest (the entire contribution). Dividends are also tax deductible.	Company must formally adopt ESOP plan. IRS must approve plan's tax qualified status. Subject to ERISA.	***Pros: Savings grow tax-deferred. No up-front cost to employees. Align employee incentives with company's long-term success.Cons: The law does not allow ESOPs to be used in partnerships and most professional corporations. Private companies must repurchase shares of departing employees, and this can become a major expense. The cost of setting up an ESOP is substantial -- $20,000+. Company ownership is diluted with the issue of any new shares.***	Recently, the average size of companies with ESOPs has been shrinking, as larger public companies have begun to terminate long-held plans. 5% of ESOPs are in public companies (median # of employees: 2,100). The median number of employees at private companies with ESOPs is 125. Over 80% of all ESOP participants also are in another company sponsored plan, often a 401(k) plan. Company owners can defer tax on the sale of stock to an ESOP if the ESOP holds 30% or more of the company's stock.

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401(k) Plans	401(k) plans allow employees to make tax-deferred contributions to a trust and direct their investments among a variety of choices, getting their money back at departure or retirement.	Employees can contribute up to $11,000 per year. The contributions are withheld from an employee's paycheck. Companies can "match" employee donations in a variety of ways.	Employee contributions and employer matches are not subject to tax at the time they are made. Low-income employees who contribute to a plan are be eligible for a tax credit on up to $2000 in contributions. Employees are taxed on the entire amount (both the contributions and the gain) as ordinary income upon withdrawal at retirement.	Employer 401(k) contributions are deductible. Small businesses (100 employees or less) are eligible for an annual tax credit of 50% on up to $1000 of administrative costs for the first three years of a new plan. Other employers can deduct as a business expense costs related to the establishment and maintenance of a retirement plan.	Third party administrators maintain 401(k) plans. 401(k) Plans must comply with ERISA. Employers must undergo certain compliance tests each year to ensure non-discrimination. Employees must be provided with a Summary Plan Description and annual statement of account information. If the company's stock is offered, employees must receive the stock fund's prospectus.	***Pros: A good benefit for employees. Company does not have to match immediately - can set up match at a later date.*** ***Cons: Administrative burden.***	Employer contributions generally take 1 of 3 forms: 1) a flat fixed-dollar amount; 2) a fixed % of each participant's pay; 3) a rate related to the employee's contribution to the plan. Many employers require one year employment before enrollment rights. Employees may legally withdraw 401(k) funds for allowable expenses (tuition, mortgage payment, etc.); cost of administering a withdrawal program can be cost-prohibitive to small companies. Employers can match contributions with company stock grants in ESOP.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. You should discuss your individual situation with us or your own attorney. We look forward to being of service to you.

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This Advisory is one of a series of business and tax advisories prepared by the attorneys at the Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author at the number listed below.

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