

**HOW DO EMPLOYERS USE DEFERRED COMPENSATION
TO CREATE EQUITY -BASED INCENTIVE PLANS
FOR KEY EMPLOYEES?**

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1. INTRODUCTION.

The following outline summarizes the most practical options available to an employer for long-term incentive arrangements based on equity growth of the employer, without selling or granting employer stock.

A. Employer Objectives. This outline assumes that an employer has the following objectives:

- Provide an added incentive for one or more key employees to increase the employer's equity value;
- Allow each key employee to realize cash from the incentive plan during or after his or her employment;
- Provide incentives to retain each key employee's services for an extended period of time;
- Prevent key employees from competing with the employer for a reasonable time after they leave its employment; and
- Avoid any sale or grant of employer stock to employees.

B. Scope of Presentation. This presentation will focus on two types of long-term equity-based incentive plans: "phantom stock" plans and stock appreciation rights plans (also known as "SARs"). Together, these long-term arrangements are often referred to as "equity-based incentives."

Some employers also use employer stock options, restricted employer stock and qualified employee stock bonus plans to create long-term incentives. However, the sale or grant of actual employer stock to employees is beyond the scope of this outline.

C. ERISA and Tax Issues. Equity-based incentives must be carefully planned to comply with the Employee Retirement Act of 1974, as amended ("ERISA"), Sections 409A and 3121(v) of the Internal Revenue Code of 1986, as amended (the "Code"), and other federal and state laws. Although these issues may be avoided by paying the plan's benefits in the form of annual bonuses, the employer's long-term incentive goal will not be met.

2. STRUCTURE OF EQUITY- BASED INCENTIVES.

A. Common Elements. Equity-based incentive plans generally have the following components:

- A means for selecting the eligible employee or employees,
- A time and formula for granting incentive units,
- An extended time period for measuring the growth of the employer's stock value,

- A formula for periodically valuing the employer stock and allocating a fraction of any increased value to eligible participants,
- "Vesting" rules that require forfeiture of some or all of the incentive value upon an employee's misconduct or early employment termination, and
- Payment terms that are affordable for the employer and definite enough to comply with Code Section 409A..

B. "Phantom Stock," SARs and the Differences Between Them.

- "Phantom Stock." A grant of a "phantom stock" unit is a deferred bonus equal to the current value of one share of the employer's common stock, based on the plan's valuation formula.

During an extended period of time, the value of the deferred bonus will go up or down whenever the employer's stock is re-valued under the plan. This means that the employee has two incentives: first, to avoid losses that would reduce his or her deferred bonus; and second, to increase profits that will cause the value of the deferred bonus to increase along with the value of employer stock.

- "SARs." A grant of a stock appreciation right is a chance to earn a deferred bonus equal to any future increase in the value of a share of the employer's common stock, based on the plan's valuation formula.

At first, a stock appreciation right (or "unit") has no value. During an extended period of time, the value of the unit may go up if the value of the employer's stock is increased under the plan. This means that the employee has two incentives: first, to increase profits that will cause the value of the unit to increase along with the value of employer stock; and second, if the unit does become valuable, to avoid losses that would reduce the value of the unit.

- Differences. The primary difference between "phantom stock" and SARs is that "phantom stock" provides a deferred bonus even if the value of the employer's stock does not increase, including a smaller bonus if the stock decreases in value. However, the employee does have a "stake" in the business and may suffer a loss of that stake.

Stock appreciation rights provide no bonus unless the employer's stock value does increase. However, unlike a shareholder, the employee does not risk losing anything if the employer's equity declines before the units have value.

- C. Record of Equity-Based Incentives. A grant of "phantom stock" or SARs is often called an "incentive unit." When the incentive unit has value, it is recorded on the employer's books as a deferred compensation account representing a liability, and an equal compensation expense is also recorded.

D. Valuation and Taxation of Incentive Units.

- Valuation. When the value of an incentive unit changes, the book account is adjusted, but not below zero. The amount of an upward adjustment is treated as added compensation expense, and a downward adjustment is a reduction of compensation expense.
- Income Tax Deferral. However, neither the book account nor any compensation expense is recognized for income tax purposes until the value of the incentive unit is paid as a deferred bonus.
- Social Security and Medicare Taxation. Nevertheless, as explained below under the heading "Tax Consequences," Social Security and Medicare taxes are due on the value of the book account at the end of the first calendar year when the incentive unit is "vested" (can no longer be forfeited), and on any increased value in each later year.

3. ERISA ISSUES.

A. Definition of "pension plan". Section 3(2)(A) of ERISA includes in the definition of regulated "pension plans" any plan, fund or program that either provides retirement income to employees or "results in the deferral of income by employees for periods extending to the termination of covered employment or beyond..." This definition is broad enough to regulate any form of deferred compensation, including SARs and "phantom stock," if the payment of benefits is systematically deferred until employment termination or beyond.

B. "Top hat" Exemption. "Pension Plans" covered by ERISA are exempt from ERISA's reporting, disclosure, participation, funding and fiduciary requirements if they are "unfunded" and maintained primarily to provide deferred compensation for a select group of management or highly compensated employees. ERISA Sections 201(2), 301(a)(3), 401(a)(1) and DOL Reg. Section 2520.104-23. The rules for these exemptions give rise to the following disclosure and plan design issues:

- Notice to DOL. The reporting and disclosure exemption applies only if the employer gives DOL a written notice of the existence of the plan in a format required by the DOL regulation mentioned above.
- Eligibility issue. Most equity-based incentive plans defer payment of the deferred bonus represented by an incentive unit until termination of employment, except for certain unusual events such as a business sale. This clearly meets the definition of "pension plan" under ERISA. The same result would be likely if payment is deferred for an extended period (such as 10 years) that is likely to continue until employment termination. Therefore, eligibility for long-term incentive units must be restricted to a select group of management or highly compensated employees that would qualify for the "top hat" exemption.
- Short-term payment option. If the employer is determined to award incentive units to a large group of employees that would not be exempt from the protection of ERISA, the

plan must pay the value of incentive units to this group as cash bonuses at a fixed time before their employment termination is likely. For example, if the average employee turnover for a group occurs after 5 years, the plan would pay all current incentive unit after 3 years, possibly in two installments. Participants could then be given new SARs to provide a continuing incentive.

- "Funding" Issue. Any commitment by the employer to buy life insurance or accumulate other assets for non-qualified retirement plan benefits may cause the plan to be "funded" and, therefore, ineligible for the ERISA exemptions mentioned above. This issue is handled in three ways, as follows:
 - (a) General Rule. In the simplest cases, all plan documents will state that benefits will be paid only from the employer's general assets; and that the employee has no rights in any assets purchased by the employer to aid in providing plan benefits. Also, the employer must not represent to the employer that any life insurance policy or other asset is "earmarked" for the employee's benefit.
 - (b) "Rabbi" Trust. If the employer creates a so-called "rabbi trust" to hold any assets that will provide liquidity for incentive plan distributions, the documents and employee communications must clearly state that such assets are subject to the claims of the employer's creditors.

4. TAX CONSEQUENCES.

A. Income Taxes.

- Effect on a key employee. Under current tax laws, an employee holding incentive units would not be liable for income taxes on the incentive units until the payment date for delivery of cash or stock. This income tax deferral is available only if the benefits represent an unsecured promise of the employer, cannot be transferred by the employee before he or she is eligible to receive them and comply with Code Section 409A. Code Section 409A allows payment of deferred compensation only upon certain events, which are: death, disability, separation from service, a fixed date or payment schedule, change in control of the business, an unforeseeable hardship or distribution to pay the employee's share of FICA and Medicare taxes (when the deferred bonus becomes vested).
- Effect on the employer. The employer will be entitled to an income tax deduction only when incentive unit payments are made in cash or stock. The employer must also withhold income taxes when cash or stock is delivered.

This tax treatment can be better for an employer than a restricted stock plan. In such plans, the participants may elect to recognize a small amount of taxable income under Code Section 83 when they purchase employer stock for a price close to market value, or receive stock of a nominal value. If a participant does elect to recognize a small amount of income upon a purchase or receipt of restricted stock, the employer then gets an income tax deduction for that small amount. However, if the participant receives a large capital gain when the restrictions end and the stock is sold, the employer receives no tax

deduction corresponding to that gain, even though the employer (if it is closely held) may be paying cash equal to the gain when it repurchases the stock.

B. FICA and Medicare Taxes. However, an employee's incentive benefits are treated differently for Social Security Retirement and Medicare payroll taxes (often called "FICA" taxes). FICA taxes will be due from the employer and the employee on the current value of any incentive benefits he or she has earned, whenever they become "vested" (all substantial forfeiture risks have expired) or when the benefits are paid, whichever occurs first. The FICA taxes will be payable as follows:

- Timing. Generally, FICA taxes will apply when the employee actually receives any benefit payments, even if some forfeiture risk remains. However, FICA taxes are deferred on unpaid amounts that may be forfeited in the future. To accomplish a long-term deferral of FICA taxes, any unpaid benefits due the employee could remain forfeitable if the employee competes with the employer, regardless of any prior "vesting," during a reasonable period of after he or she terminates employment.

For example, if benefits remain forfeitable for competition until three years after an employee's employment termination, and benefits are paid over a 5-year period after the termination, FICA taxes would be due on each of the first three installments only when it is paid. However, FICA taxes would be due on the remaining two unpaid installments at the end of the three year non-competition period, even though the last two installments are not yet due.

- FICA Tax Rates. The highest rate of FICA tax is 15.3%, one-half paid by the employer and one-half paid by the employee (through withholding). The 15.3% rate is due only on the Social Security Wage Base amount (\$106,800 in 2009) paid to the employee by the employer during a calendar year. If the employee's benefit payments occur in a year when the employer has already paid him or her the Wage Base amount in salary, the excess amount is FICA taxable only at the Medicare tax rate (1.45% by the employer and 1.45% by the employee).

5. CASE STUDY OF A SAR PLAN FOR A CLOSELY HELD EMPLOYER.

A. Summary of Incentive Design.

- Grant of SAR Units. A closely held employer may decide to award long-term SAR units to "Linda Key", an non-owner key employee at the beginning of 2010. These units would provide the key employee with an incentive bonus payable in installments beginning after a 10-year measurement period. A lesser amount may be payable if she leaves the employer at an earlier time without forfeiting all of the units. The number of units would be equal to 10% of the employer's outstanding shares.
- Base Value of Stock. The value of a share of the employer's stock would first be estimated, as of December 31, 2009, by using the formula described below. This value will provide a base for measuring future growth in the stock's value after 2009. To keep the SAR units on a par with actual stock, the business value could be divided by the

number of actual shares plus the number of SAR units. However, the initial value of the key employee's SAR units would be zero.

- Annual Valuation of SAR Units. After the end of each year during the 10-year measurement period in which the SAR units remain outstanding, the key employee's units would be re-valued, based on the incentive formula. The revised unit value would be equal to 10% of the latest formula value of a share of the employer's stock, less 10% of the stock's formula value at the end of 2009. The SAR units would stop growing before the end of the 10-year period if the key employee's employment ends before that date or the business is sold. An early termination of employment or misconduct would also result in a partial or complete forfeiture, as explained below.
- Effect of SAR Units. In other words, the SAR units would give the key employee a deferred bonus equal to 10% of the employer's estimated equity growth during a measurement period beginning January 1, 2010, and ending at the end of 2019, the date her employment terminates or the date the business is sold, whichever comes first. As explained below, the incentive percentage would be less than 10%, if a forfeiture occurs.
- Effect of Payment. If the SAR units are paid after 10 years, they could be replaced with new units that would measure growth only after those payments.

B. Possible Extension of Measurement Period and Payment Schedule. The employer and key employee may prefer to continue the growth of incentive units beyond the first 10-year period, if no other payment event occurs earlier. If so, the SAR agreement could be amended (at least one year before payment is due), to extend the measurement period for any period of at least five years, and defer the payments otherwise due after 10 years.

However, Code Section 409A does not allow early payments or any other payment delay, except in very limited situations.

C. Valuation Formula. The valuation formula could be the greater of the employer's book equity value or a multiple of earnings, with the following adjustments:

- Add back to net profits or losses any part of the owner's pay that exceeds an agreed amount, such as 2009 pay increased annually by 10% or another agreed percentage. The owner's pay could be defined to include any costly benefits and "perks" not available to other employees.
- Add back to net profits or losses any accrued cost of the key employee's incentive units.
- Remove from net profits or losses any income or loss from investments unrelated to the employer's business.
- Possibly deduct taxes on the employer's income, including taxes payable by the owner while the employer is a "Subchapter S" corporation. However, this may be omitted if incentive payments are made fairly soon, creating a tax deduction for the employer.

- However, if the employer' book value may be radically changed by capital withdrawals or similar events, the value of the units may simply be based on a share of accumulated net profits (net of any losses) during the measurement period. This plan would look more like a deferred profit sharing plan.

D. Effect of Business Sale. If a majority of the employer's stock or substantially all of its assets are sold during the 10-year measuring period, or before any earlier date when the key employee's payments start, the key employee could receive the vested percentage of her incentive units, valued at the sale price per share of employer stock. If such a sale occurs, the key employee's unit value could be paid in a lump sum (to speed up the employer's tax deduction), or any less favorable terms received by the employer or its shareholders.

E. Maximum Value of Units. The incentive unit value could be limited to a maximum dollar amount per unit, especially if equity growth will not always result in cash flow.

F. Forfeiture and Vesting. Some or all of the key employee's incentive units should be forfeited if any of the following events occur before her units are fully paid to her:

- Discharge for Misconduct. If the key employee is discharged at any time for serious misconduct (such as theft or gross neglect), 100% of her units would be forfeited, except for any amounts paid before the misconduct. To protect the key employee, the definition of "misconduct" would not include poor performance, if she has exerted her best efforts in good faith.
- Competition after Termination. If the key employee competes with the employer within a stated period after leaving the employer, 100% of her units would be forfeited, except for amounts paid before the competition began. "Competition" would include becoming a competitor or working for one, disclosing confidential data or hiring employer employees.
- Early Termination. If the key employee's employment ends for any reason (other than discharge for misconduct) before a five-year vesting period is over, and she does not compete with the employer within the sated period after she leaves, her units would be frozen in value and some would be forfeited, based on the following vesting schedule:

Date of Termination	Forfeited %	Vested %
During 2010	100%	0%
During 2011	80%	20%
During 2012	60%	40%
During 2013	40%	60%
During 2014	20%	80%
After 2014	0%	100%

Nevertheless, even the "vested" percentage will be forfeited if the key employee is discharged for misconduct or competes with the employer, as explained above.

- Other Vesting Options. Some employers use a longer vesting period or require attainment of a certain age before employment termination. An extended vesting period is a good idea if the employer uses a measuring period longer than 10 years.

Some employers also waive any time-related forfeitures upon a sale of the employer or its assets, or upon the employee's death or extended disability, or even if the employee is discharged without misconduct.

However, those waivers may not be practical in this sample case, because those events (except for a sale) would cause the employer to lose a key employee. If "key person" life insurance is used, the unit benefits could be 100% vested upon an early death.

G. Payment Terms. The benefits relating to any incentive units that are not forfeited would be payable on the following terms:

- Dividend Equivalents. The employer could pay a bonus to the key employee whenever dividends are paid on the employer's stock, in a amount equal to the dividends paid on a number of shares equal to the number of incentive units. This will make up for the loss of equity value when a dividend is paid. However, the dividend bonus should be deferred, with interest, until the units are vested; and could be deferred until the incentive units are paid.
- Valuation Date. If no business sale occurs, incentive payments would be based on the formula value of vested units at the end of the last fiscal year (or month) ending before payments become due. Some plans revise the value as of the last month ending before termination, if a year-to-date loss has occurred. If three year averages are used in the proposed formula, this may make such an adjustment unnecessary. If a business sale occurs, the valuation date would be the closing date.
- Beginning Date. If the key employee stays for the entire 10-year measurement period, the first payment would be made three months after the end of that period. If the key employee's employment ends before the end of the measurement period, payments would begin after her employment ends, but no earlier than three months after the most recent valuation date. The three-month delay would allow time to figure the latest unit value. If a business sale occurs, the first payment date would be the closing date.
- Installments. The value of vested units could be paid in five (or more) annual installments, with interest at a market rate set when payment starts. If the unit value is not limited, the payment period could be extended if the total value exceeds a threshold level, such as \$500,000. The agreement should permit the employer to buy life insurance on the key employee, so that insurance proceeds can be used to prepay benefit installments in a lump sum at death, and cover any costs of replacing the employee.

- Limited Payment Delays to Protect Employer. Code Section 409A allows an employer to delay fixed payment dates as follows:
 - (a) To comply with a maximum payment formula, such as a fixed percentage of the employer's net income; and
 - (b) A temporary delay until the end of the calendar year when the payment is due or, if later, up to two and one-half months.

H. Employment and Incentive Agreement. The employer would enter into a written employment and incentive agreement with the key employee, including the following:

- A description of her general responsibilities, subject to change by the employer.
- Her base salary and any other compensation and benefits to be paid by the employer.
- All of the SAR provisions; including the number of units and the valuation, forfeiture, vesting and payment provisions.
- Her promises not to compete, use or disclose confidential data or solicit termination of employer employees.
- Rules for termination of the key employee's employment with reasonable notice, such 30 days. Any added severance pay commitment should not be needed, because the vested part of her incentive units would help her deal with any unexpected termination.
- A statement that the incentive units do not give the key employee any shareholder rights, and a statement that the units represent only an unfunded promise that is not assignable or transferable. The latter statement is required to defer the income tax effect until the benefits are paid.