Incentive Compensation Considerations for Technology Companies


By Michelle Capezza

Compensating employees with equity and other forms of incentive compensation can be a useful tool for start-up companies that have cash flow challenges, for developed companies that want to stay competitive in their industry, or as a means to incentivize employees to help build value in the company.

There are many different ways to design equity and incentive programs for the modern workforce, and numerous requirements that these programs must satisfy. A first step in designing such a program requires a determination as to the types of awards to provide employees. This article highlights some of the most common types of awards used in the technology industry today to motivate and/or retain highly-skilled workers.

**Stock Options**—Stock options do not require a cash outlay from a company. Options provide employees with a right to acquire equity in the company during a specified period of time at a pre-determined price (and, in light of Section 409A of the Internal Revenue Code, options (and SARs) must be issued with an exercise price equal to the fair market value of the award on the date of grant to avoid potential tax penalties). Options can be in the form of incentive stock options (ISOs) or nonqualified stock options. There are numerous tax code requirements that must be followed in order for options to be considered ISOs which can provide the employee with capital gains treatment upon the sale of the stock acquired after the exercise of the ISOs.

As a general example, if an employee is granted an option with a fair market value on the date of grant of $5 with respect to 50,000 shares, and upon exercise of the option three years later the stock is worth $10.00 per share, the option would have a value of $250,000 upon its exercise (50,000 shares times $5.00 appreciation per share) and the employee would receive 50,000 shares upon exercise. However, the employee must pay an exercise price of $250,000, and, if this is paid through a sale of existing shares, the employee would then have a remaining balance of 25,000 shares.

In down economic times, many options are “underwater” and considered valueless when the exercise price exceeds the current value of the options. This occurrence forces many companies to explore whether an option exchange program makes sense and whether shareholder approval can be obtained for such a program. Also, there is potential shareholder dilution which results as options are exercised. Despite the downside, options continue to remain an important element of compensation in the technology industry.

**Stock Appreciation Rights**—SARs allow employees to receive the value of the appreciation in equity over the fair market value of the award on the date of grant. Thus, if in the example above the employee is granted a SAR with a fair market value on the date of grant of $5.00 with respect to 50,000 shares, and upon exercise of the SAR three years later the stock is worth $10 per share, the SAR would have a value of $250,000 upon its exercise (50,000 shares times $5 appreciation per share) and the employee would receive 25,000 shares (although, it is possible to settle SARs in cash and equity). The resulting shares are the same as with the options, however, with a SAR, the
employee receives the appreciation in equity upon exercise without having to pay an exercise price (whereas, with options, the employee must pay the exercise price either through a cashless exercise program or other means). Also, by utilizing SARs, the company has less shares outstanding than occurs when options are utilized as a compensation tool.

With changes in accounting rules under FAS 123R, both options and SARs are now afforded the same accounting treatment (namely, a charge to the company’s income); thus, there is less incentive for companies to award options as opposed to SARs. But, SARs cannot provide the same potential tax advantages to the employee as ISOs. When the employee exercises the SAR, he or she recognizes ordinary income on the cash or stock paid and the company would be entitled to a compensation deduction at the same time, in the same amount.

**Restricted Stock**—Restricted stock can provide for the actual grant of shares of the company’s stock to employees either without cost or at a reduced price, subject to restrictions on transferability and substantial risk of forfeiture (in other words, vesting or lapsing of restrictions). Conditions such as continuation of employment for certain time periods and/or attainment of performance goals can be imposed on employees who are granted restricted stock before they become vested in such stock. Thus, with restricted stock, while the employee becomes a shareholder upon grant of the stock, they have contingent ownership and cannot sell or dispose of the stock until they become vested. This can help retain an employee’s service to the company. And, if the employee decides to make an election under Section 83(b) of the Internal Revenue Code to pay federal income tax on the fair market value of the restricted stock at the time it is granted, he or she may pay tax on the appreciation of such stock upon a future disposition of such stock, at long-term capital gain rates. The company will be entitled to a tax deduction when the employee recognizes income.

Possible disadvantages of granting restricted stock to employees include increasing the issued and outstanding stock of the company and reducing earnings per share. Also, where restricted stock vests solely by the passage of time that the employee works for the company, the employee will receive an award even if the value of the company does not increase. Thus, restricted stock does not always translate to employees as a motivational tool but, it can be a useful retention tool. Private companies may be less likely to award restricted stock or options since there is no market for the stock once an employee acquires it. However, start-up companies may wish to grant restricted stock so that employees can make an 83(b) election at the time when the stock is granted and take advantage of any upside as capital gain.

**Restricted Stock Units**—For corporations and entities that are not corporations (such as LLCs), restricted stock units provide another way to award restricted equity interests to employees. RSUs are units which are valued based on the company’s stock price. RSUs are subject to vesting requirements as with restricted stock, and the recipient can receive a distribution of his or her RSUs in shares of stock or cash. RSUs are generally not taxable to the recipient until he or she receives a distribution of the underlying stock. However, RSUs are considered deferred compensation and must comply with the requirements of Section 409A of the Code (such as a compliant vesting and payment schedule) in order to avoid tax penalties. The company will be entitled to a tax deduction when the employee recognizes taxable ordinary income.

**Phantom Equity**—Phantom stock plans can provide employees with contractual rights to share in the economic benefits of being a shareholder without providing actual stock (that has a dilutive effect) or the rights of a shareholder under state law. The employee can be awarded phantom stock or units that mirror a specific number and value of actual stock. The award can equal the value of the shares or just an amount of appreciation. When the employee vests
in the phantom stock (or units) and it appreciates in value, the employee can share in the proceeds of a company when it is sold based on the percentage he or she owns as a result of having been granted the phantom stock. When the employee exercises phantom stock, he or she recognizes ordinary income on the cash received and the company would be entitled to a compensation deduction at the same time, in the same amount. Phantom stock is also subject to Section 409A of the Internal Revenue Code and must comply with its requirements.

**Bonus Plans**—While bonus programs can be designed to provide employees with cash upon meeting certain annual targets, they might not always provide employees with the same sense of ownership in the company, or serve as the same type of longterm retention tool, as an equity incentive program. However, change-in-control bonus programs may serve to retain employees for longer periods of time as they may incentivize employees to build a business in exchange for rewards that may be provided upon the sale of the company.

Certainly there are other forms of incentive compensation, and variations on the methods mentioned above, that make sense for technology companies. In addition, these programs must comply with various tax and securities laws requirements, and they have accounting implications. Considering the types of awards that may be granted to employees is just a first step toward developing a competitive incentive program for employees.