Employee Incentive Compensation: A Primer

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Employee Incentive Compensation: A Primer

1. OVERVIEW

1.1 Key Issues

"Incentive compensation" generally refers to special incentives granted to one or more key individuals to generate unique value for the employer organization and to encourage long-term loyalty of such individuals. The key elements of incentive compensation are:

- Corporate governance (dilution of shareholdings of others, and conflicts between management incentives and accountability to shareholders for volatile earnings);
- Tax optimization;
- Accounting treatment relating to dilution of shares (increasing fully allocated shares as if converted), dilution of earnings per share, treatment of option shares as an expense, and variable accounting for "underwater" options where the share value is less than the option exercise price); and
- Definition of goals and performance metrics, as well as ongoing evaluation of the suitability of such goals to the employer's economics.

This commentary focuses on the tax treatment of incentive compensation structures for closely-held companies, including startups and SME's, that need long-term services of key employees for growth and stability. We do not address the details of broad-based complex incentive plans that require the establishment of trusts, the compliance with fiduciary duty of trustees or with duties of non-discrimination among employees. In considering any type of incentives, the Board of Directors (or Managers) must consider a variety of issues.

1.2 Domestic Businesses

Domestic U.S. employers can offer a variety of incentive compensation packages to U.S. employees.

1.3 International Businesses

From a U.S. standpoint, U.S. businesses that are subsidiaries of foreign businesses can offer many of the same incentives that a U.S. domestic business can offer. For example, stock options, stock appreciation rights and phantom stock may be granted for shares in the foreign parent.

From a foreign standpoint, incentive compensation for executives of a U.S. subsidiary requires compliance with foreign tax and employment rules. Such U.S. subsidiaries face unique challenges in defining and rewarding incentives for key U.S. executives. If the U.S. executive is being seconded from an existing post in the foreign company, termination of statutory rights under foreign law should be clarified before awarding any U.S. employment. For U.S. local executives, their contribution to the value of the parent company might be less measurable than their contribution to the value of the U.S. company. In short, consultations with foreign counsel are recommended to consider how different legal and tax systems might govern the same issues.

2. QUALIFYING INCENTIVE STOCK OPTION PLANS ("QISO's")

2.1 Tax Attributes of QISO's

The QISO is a creature of U.S. tax law. As a result, the tax advantages are hard to beat.

2.1.1 Deferral of Income Tax

In a stock option, the value of the benefit obtained is the difference between the future sale price of the option shares minus the amount paid by the employee to exercise the option and purchase the option shares in a private issuance by the employer.

In a QISO, tax is deferred till sale of the option shares, which is a liquidity event.[1] The employee pays no tax when the stock option is awarded, when the stock option vests (upon lapse of time and meeting any other conditions), or upon exercise of the option and acquisition of the option shares.

2.1.2 Capital Gain upon Sale

In a QISO, the taxable sale of the option shares is treated as a capital gain. Assuming the option shares are held for more than a year after issuance, the capital gain is "long-term," and thus subject to a 20% federal personal income tax return compared to a 39.6% federal maximum rate for ordinary income.

2.1.3 No Corporate Deduction

Upon issuance of QISO option shares, the employer gets no income tax deduction with respect to the shares so transferred.[2]

2.1.4 No Corporate Income

Upon issuance of QISO option shares, the employer does not include any amount in its taxable income. No amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.[3]

2.1.5 No Social Security Taxes

Compensation through QISO's is not treated as ordinary salary income. As a result, it is not subject to the 7.65% federal FICA/FUTA/Medicare taxes on wages.

2.1.6 Deferred Vesting

While the Internal Revenue Code (IRC) does not define a minimum delay before options are vested, the Code does require some deferral of vesting. Traditionally, for startups, vesting may occur in different stages, such as a "one-year cliff vesting" (with no vesting for a year) followed by monthly fractional vesting for the remaining of the vesting period. Typical vesting periods are three or four years for startups.

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[1] Internal Revenue Code ("IRC"), § 421(a)(1).
[2] IRC, § 421(a)(2).
[3] IRC, § 421(a)(3).

2.2 Optimal Context

2.2.1 Flexible Contexts

A QISO is optimal for many different contexts. A QISO is available only for corporations, not LLC's or partnerships. Optimization does not depend on timing since the employer can designate all employees as eligible and can issue options at any time. Unlike phantom stock, a real stock option must be supported by reservation of unissued shares. In some cases, this may require authorization of additional shares, which must be approved by the incumbent stockholders.

2.2.2 Ineffective Contexts

A QISO might not be appropriate where the value of the option shares is extraordinarily high, requiring the employee option-holder to pay a high price upon exercise. Further, a QISO is not effective where, in the short-term, the entire company is expected to be sold. A well-drafted plan can overcome this issue by requiring some form of accommodation upon a merger that would result in continuation of the plan after a merger.

2.2.3 "Out of the Money" (or "Underwater") Options

What happens when the QISO Plan is based on company valuations that were excessive? Consider the problem of employees with options whose exercise price is higher than the current company's valuation for such shares? These options are "out of the money" and would never be exercised unless the company price went back up.

2.2.3.1 Repricing

Repricing of such options creates problems for both the employee and the employer. Till accounting rules changed several years ago, companies might simply cancel the existing stock options and grant new stock options exercisable at a price equal to the current fair market value of the underlying stock. However, such simple repricing generates unfavorable accounting treatment. In such cases, companies should consider the alternatives from the standpoint of corporate governance, tax and accounting aspects.

From the standpoint of corporate governance, the Board of Directors might have a conflict of interest for "failing" to build the business and thus maintain a strong share price. How do the other shareholders feel about favoring employees (including senior executives) in comparison to existing shareholders, whose shares have declined in value? Repricing for managers could be seen as unjust enrichment of the managers at the expense of the existing shareholders.

For accounting, repricing of options triggers a rule under Financial Accounting Standards Board (or "FASB") rules that would shift the accounting treatment from stable and predictable to a "variable accounting method" requiring of constant re-measurement of the difference between the exercise price and the fair market value. This messy result suggests alternatives should be adopted.

2.2.3.2 Cancellation and Delayed Reissuance.

The company might cancel existing underwater options and wait six months and a day before issuing new options at the "lower" market value. The timing gap creates a risk for the employee that the stock value might rise during such period.

2.2.3.3 Restricted Stock Award

The company might simply offer a "restricted stock" award and cancel the underwater stock options. The employee would have to pay immediately for new stock, but the employee might not have access to enough cash to pay for it.

2.2.3.4 New Grant, No Cancellation

Or the company might just issue new options at the new value. If the value rises quickly, the employee gets a windfall when the underwater options are now in the money. Existing shareholders and other option holders would suffer unwarranted dilution.

2.2.4 Sale by Grantee at Less than Option Price

Unlike the "underwater options" (where the employee has not exercised the option), after exercise, the option shares might decline in value. If the amount realized by the employee on sales of option shares is less than value at exercise, resulting in a tax loss, then the amount which is includible in the employee's gross income, and the amount which is deductible from the income of the employer corporation, as compensation attributable to the exercise of such option "shall not exceed the excess (if any) of the amount realized on such sale or exchange over the adjusted basis of such share."[1]

2.3 Design of the Stock Option Plan

To qualify as a stock option plan, the employer must design the plan to comply with basic rules.

2.3.1 The Issuer of the Stock

The stock option must be granted by the employer corporation or its parent or subsidiary corporation.[2]

2.3.2 The Option Pool of Shares

The option plan must specify the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options.[3] Typically, option pools are between 10% and 20% of the total authorized capital. Any larger pool could impair the company's ability to attract investors and likewise impair the ability to the founders and existing shareholders to control the common stock.

2.3.3 Date of Grant

The option must be granted within 10 years from the date such plan is adopted, or the date such plan is approved by the stockholders, whichever is earlier.[4]

2.3.1 Date of Exercise of Option.

The grant of the option must state, by its terms, that it is not exercisable after the expiration of 10 years from the date such option is granted.[5]

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1 IRC, § 422(c)(2).
2 IRC, § 422(b).
3 IRC, § 422(b)(1).
4 IRC, § 422(b)(2).
5 IRC, § 422(b)(3).

2.3.2 Non-Transferability

By its terms, the qualifying stock option must not be transferable by the grantee otherwise than by will or the laws of descent and distribution. It must be exercisable, during his lifetime, only by him or her.[1]

2.3.3 The Grantee

2.3.3.1 Employee

The grantee of the QISO stock must be an employee of the company, its parent or subsidiary. Independent contractors are not eligible. (This suggests some alternative such as issuance of shares for services under a Section 83(b) election).

2.3.3.2 Maximum 10% Shareholding

Further, when the option is granted, the grantee may not own, stock possessing more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.[2]

However, a shareholder with more than 10% of combined voting power can get qualified options if, when the option is granted, (i) the option price is at least 110 percent of the fair market value of the stock subject to the option and (ii) such option, by its terms, cannot be exercised later than 5 years after the date when such option is granted.[3] This exception gives flexibility to restructure the shareholdings where a company founder is told by the investors that the founder must put some of his stock equity at risk as a condition of their agreement to invest.

2.3.1 Method of Plan Adoption by the Employer

To be valid for tax purposes, the QISO plan must be approved by the Board of Directors and ratified by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted.[4]

2.4 Design of the Grant

Even if all other criteria are satisfied, the grant of the option must clearly express that it is a qualified stock option under the plan.[5]

2.5 Valuation Issues

2.5.1 Vesting Conditions are Disregarded

For stock option purposes, as for Section 83(b) elections, the fair market value of stock shall be determined without regard to any restriction other than a restriction which, by its terms, will never lapse.[6]

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[1] IRC, § 422(b)(5).
[2] IRC, § 422(b)(6).
[3] IRC, § 422(c)(5).
[4] IRC, § 422(b)(1).
[5] IRC, § 422(b).
[6] IRC, § 422(c)(7).

2.5.2 Good Faith.

The option exercise price must be not less than the fair market value of the stock at the time such option is granted.[1] Valuation being an art and not a science, valuations may fluctuate, depending on the methodology used. Some methodologies (such as discounted cash flow) do not apply to startups, which cannot measure the value of pending patents, trade secrets or new business methods where there might not be any cash flow. Other valuation methodologies (such as comparable sales) do not apply where the value is untested due to the novelty of the business. Accordingly, the tax law accepts "seat of the pants" estimated valuations of stock for QISO purposes, if done "in good faith."[2]

2.5.3 Repricing

To accommodate changes, the employer's company's stock option plan should be reviewed to make sure that it does not preclude a repricing of stock options.

2.6 Timing Issues

To qualify for QISO treatment, the employee selling option shares must meet two requirements.

2.6.1 Holding Periods

First, such selling employee shareholder must not sell any of the option shares within 2 years after the date of the granting of the option nor within 1 year after the transfer of such share to him (after the exercise).[3]

2.6.2 Employee Status

Second, all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual must have been an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a M&A transaction to which section 424(a) applies.[4] (For disabled employees, the three-month period is extended to 12 months.)[5]

2.6.3 $100,000/Year Limitation

Employees should be wary of the risk that other option holders might exercise their options and thus disqualify their sales. If more than $100,000 in stock value is exercised in one calendar year, the excess is treated as non-qualifying options.[6] Loss of QISO status is based on "first

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[1] IRC, § 422(b)(4).

[2] IRC, § 422(c)(1). "If a share of stock is transferred pursuant to the exercise by an individual of an option which would fail to qualify as an incentive stock option under subsection (b) because there was a failure in an attempt, made in good faith, to meet the requirement of subsection (b)(4), the requirement of subsection (b)(4) shall be considered to have been met." A similar rule applies to the valuation for the $100,000 threshold under IRC § 422(d).

[3] IRC, § 422(a).

[4] IRC, § 422(a).

[5] IRC, § 422(c)(6).

[6] To the extent that the aggregate fair market value of stock with respect to which incentive stock options (determined without regard to this rule) are exercisable for the 1st time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000, such options shall be treated as options which are not incentive stock options. IRC, § 422(d)(1).

come, first-served" basis: one person selling option shares for more than $100,000 could prevent all others from getting the tax benefits.

As a result, employees holding QISO option shares should plan to sell, if at all, at the beginning of a calendar year. Of course, such sales may be governed by rights-of-first-refusal under a stockholders' agreement.

2.7 Accounting Issues

Accounting issues are governed by APB Opinion 25 and FASB Statement of Accounting Principles 123. These are complex documents and cannot be briefly summarized. The accounting treatment of options does have some implications on financial statements. For example, Under FASB Statement of Accounting Principles 123, for accounting purposes, the employer must include the number of option shares in the total number of shares deemed issued, thereby diluting the value of "earnings per share."

3. STOCK IN RETURN FOR SERVICES RENDERED (Section 83(b))

3.1 Tax Attributes

3.1.1 Current Taxation as Ordinary Income; No Deferral of Income Tax

When any person receives property (including corporate shares, LLC membership interests or partnership interests) in consideration of services, such property is ordinarily taxable as ordinary income. Worse, such property is an "ordinary" asset and generates "ordinary" income upon eventual sale.

To give incentives for individuals to render services to startups and other entities on an "at risk" basis, Code Section 83(b) permits an election by such an individual to pay tax on the property received, pay tax on it currently and convert the property to a "capital asset" for future capital gains taxation. There's only one "catch." The individual's rights must be subject to substantial risk of forfeiture.[1] Yet the individual must pay the full tax on the full value of the "property" without regard to the fact that the individual's ownership is subject to a "substantial risk of forfeiture.

If such an election is made, the individual must pay current tax on difference between (1) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse)[2], over (2) the amount (if any) paid for such property.[3]

Once such election is made, no further tax on the receipt of the property is owed. However, if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.[4]

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[1] IRC, § 83(c)(1): "The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual."

[2] Special provisions apply to valuations for restrictions that never lapse. See IRC 83(d).

[3] IRC, § 83(b)(1).

[4] IRC, § 83(b)(1).

3.1.2 Capital Gain upon Future Sale

The Section 83(b) election converts the property to a capital asset. However, for determining whether the holding period is a long-term or short-term, "there shall be included only the period beginning at the first time his rights in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier."[1]

3.2 Optimal Context

Section 83(b) elections can be used optimally for early-stage startups with low fair market value. In contrast, if the value of the "property" is too high, the individual providing services has no incentive to pay a significant tax and risk forfeiture due to the whim of the company's founder or executives.

For LLC's and partnerships, Section 83(b) may be the service provider's only hope of getting some equity. Such entities lack the corporate form that supports QISO's.

Individuals considering a Section 83(b) election may wish to reduce the risk of forfeiture by shortening the period in which forfeiture may occur. This approach creates internal conflict with the founders and may invite early termination.

3.3 Design of the 83(b) Election

3.3.1 Substantial Risk of Forfeiture

The rights of a person in property are "subject to a substantial risk of forfeiture" if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual. Thus, a simple vesting period will suffice, where the individual could be "fired" at any time.

3.4 Valuation Issues

Valuation of the "property" must be done without regard to the existence of a risk of forfeiture.

3.5 Timing Issues

Timing of the issuance of ownership interests in a company makes a difference. The individual must file any Section 83(b) election within 30 days after the date of the transfer of property to him or her. The election may not be revoked except with IRS consent.

4. "DEFERRAL STOCK" IN RETURN FOR SERVICES RENDERED (Section 83(i))

4.1 Suitability for Joint Exits

'Deferral stock' is a new concept for promoting broad stock ownership of privately owned corporations among ordinary employees under the 2017 Tax Cuts and Jobs Act. With a suitable drag-along clause, deferral stock options or grants can promote support for a joint exit. Under grants of options under stock option plan or grants of restricted stock (subject to forfeiture), an employee receiving restricted stock can defer taxation on the value of such stock in a later year.

[1] IRC, § 83(f).

4.2 Eligibility of the Employer Corporation to Issue Deferral Stock

A corporate employer must meet two tests to be eligible to issue "qualified" (deferral) stock in the current taxable year: private ownership and an 80% participation rate.

- *Private Ownership:* None of the stock of such corporation (or its predecessor(s)) can be "readily tradable on an established securities market" in any prior calendar year.
- *Written Plan:* The corporation must have a written plan under which, in such calendar year, not less than 80 percent of all employees who provide services to such corporation in the United States (or any possession of the United States) are granted stock options, or are granted restricted stock units, with the same rights and privileges to receive qualified stock.

4.3 80% Employee Participation

To meet the 80% participation text, the restricted stock plan or stock option plan must give more than a '*de minimis*' number of 'deferral stock' shares to at least eighty percent of the U.S. situated employees. Current or former one percent owners, CEOs, CFOs and the four highest compensated employees are "excluded employees" and cannot participate.

4.4 Valuation Issues

The deferral applies to the unrealized gain on the employer's shares. Thus, if (at the time of issuance) the deferral stock has a fair market value of $10.00 upon issuance of the option or restricted stock plan, and the employee pays $1.00 upon exercise of the option, the deferred gain is $9.00. For restricted stock (where the employee pays nothing), the entire fair market value is taxable.

4.5 Filing a Tax Election with 30 Days

The employee must file a Section 83(i) election within thirty days after the first date when the rights of the employee in the deferral stock become transferable or are not subject to a substantial risk of forfeiture. Unlike an 83(b) election, 'deferral stock' treatment is available only to U.S.-based employees. To avoid possible favoritism for some employees of operations conducted by multiple affiliated entities, all affiliated entities are counted for purposes of the eighty percent coverage test.

4.6 Timing Issues: Taxable on Lapse of Certain Restrictions

The delayed timing of taxation of receipt of 'deferral stock' as taxable income depends on five possible events. Generally, the tax must be paid when the restrictions on transfer lapse or when the stock could be sold on a securities market.

Thus, "deferral stock" ("qualified stock") loses its tax-deferred status when any of the following events occurs. Upon such an event, the employee must declare the value of such shares (as of the date when issued). Generally, such events occur when the deferral stock becomes a liquid asset. However, other events might accelerate taxability, so both the employer and the employee should be alert to avoid loss of the deferral.

In summary, tax deferral ends on any of the following events[1]:

[1] IRC, § 83(i)(1)(B).

- the first date when such qualified stock becomes transferable (including, solely for purposes of this clause, becoming transferable to the employer);
- the date when the employee first becomes an "excluded employee";
- the first date on which any stock of the corporation which issued the qualified stock becomes readily tradable on an established securities market (under Treasury regulations);
- the date that is 5 years after the first date the rights of the employee in such stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier; or
- the date when the employee revokes the election to defer taxation on such deferral stock (pursuant to Treasury regulations).

4.7 Critique

As a result, the deferral will end soon enough. If there is no sale of the company (and receipt of cash by the employee) within five years after any deferral stock becomes fully vested, the employee will have to pay taxes from sources other than proceeds of sale. That's phantom income. As a result, "deferral stock" plans should be adopted only where there are adequate opportunities for liquidity for the employees after that five-year period.

5. STOCK APPRECIATION RIGHTS AND PHANTOM STOCK

Stock appreciation rights give the holder a right to receive a payment that is equivalent to the increase in value of equity over a base value. Unlike stock options and property for services, SAR's and phantom stock (which is an SAR with a zero base value) are not equity or equity equivalents. They are bookkeeping entries of a company's liability to the rights holder. If the company goes bankrupt, or is unable to pay due to insolvency considerations, the SAR holder has no recourse other than as general unsecured creditor.

5.1 Tax Attributes

5.1.1 Deferral of Income Tax

As a promise to pay, an SAR or phantom stock defers the taxable event till the future payment.

5.1.2 Ordinary Gain upon Sale

As future payment for services, SAR's and phantom stock generate ordinary gain in consideration of such services.

5.1.3 Deferred Vesting

Vesting may be made dependent on future conditions, such as continued employment, achievement of specific goals or other scenarios.

5.2 Optimal Context

SAR's and phantom stock offer excellent value where the fair market value of the shares (or other equity) is already relatively high. They are effective as incentives to retain key senior executives who might leave the company before a planned imminent sale to a strategic investor, which is a scenario for short-term reward. Longer term, SAR's and phantom stock are not as effective as QISO's, which can be used for a broad range of employees and provide longer term stable incentives. Further, SAR's and phantom stock pose valuation problems for closely held companies.

5.3 Design of the SAR Award

Awarding an SAR or phantom stock involves a valuation of the company's stock as of a designated commencement date and a similar valuation upon an ending date.

5.4 Valuation Issues

Technically, an SAR can be issued for any arbitrary value selected by management. In practice, care must be given to avoid a valuation process that might conflict with securities law disclosures or other forms of incentive compensation.

5.5 Timing Issues

There are no special timing issues. No special reporting deadlines apply.

6. QUALIFIED PENSION, PROFIT-SHARING, AND STOCK BONUS PLANS (ERISA)

Qualified pension, profit-sharing, and stock bonus plans require establishment of a trust under which the employer makes contributions for employees under defined rules. The trust may not be invaded by the employer for any non-qualifying payment. Such plans must comply with both tax[1] and ERISA rules. There are fiduciary duties, standards for minimum participation by all employees and a duty not to discriminate in favor of "highly compensated employees." Such plans are beyond the scope of this analysis.

7. DEFERRED ORDINARY INCOME (Section 409A)

Special incentives may arise from deferring cash payments to employees under Section 409A. Tax deferral can smooth out volatile income, thus helping reduce income tax by staying in lower rate brackets.

7.1 Tax Attributes

7.1.1 Deferral of Income Tax

By complying with Section 409A, a deferred compensation plan allows an employee to defer receipt and taxation of incentive compensation. If the requirements are not satisfied, all compensation deferred under the plan for the current taxable year and all preceding taxable years shall be includible in gross income for the taxable year "to the extent not subject to a substantial risk of forfeiture and not previously included in gross income."[2] Failure to satisfy the rules results in a 20% tax penalty.[3]

7.1.2 Ordinary Income

Deferred compensation under Section 409A is ordinary income.

7.2 Optimal Context

Deferred compensation plans under Section 409A are best for rewarding key senior executives. However, they do not require a substantial risk of forfeiture, and without an express condition for vesting or payment, the executives are not at risk of forfeiture.

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[1] IRC, 401, 410 and 414(q).
[2] IRC, § 409A(a)(1)(A)(i).
[3] IRC, § 409A(a)(1)(B).

7.3 Design of the Award of Deferred Compensation

A deferred payment plan must actually defer payments of the "deferred compensation." Six exceptions permit distribution of the compensation "early" in case of:

- separation from service as determined by the Secretary (except for key employees in publicly traded companies, who must wait 6 months after separation);
- the date the participant becomes "disabled";
- death;
- a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation;
- to the extent provided by IRS, a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or
- the occurrence of an unforeseeable emergency.[1]

7.4 Valuation Issues

Generally, 409A deferred compensation is paid in cash. Valuation issues arise if the deferred compensation is stock or other non-cash asset.

7.5 Timing Issues

When may a participating employee decide to defer compensation under section 409A? In making the decision to defer, the participant may elect a deferral of current year's compensation only if the election to defer such compensation is made not later than the close of the preceding taxable year (or otherwise under regulations). For first-year participation in the plan, the employee must elect within 30 days after the date the participant becomes eligible to participate in such plan. Finally for performance-based compensation based on services performed over a period of at least 12 months, the employee's election may be made no later than 6 months before the end of the period.[2] Subsequently, changes to the timing or nature of payments (in cash or shares) require a 12-month advance notice and deferral of payment to not more than five years.

8. BONUSES

Bonuses are traditionally paid after the completion of a fiscal year, upon the employee's successful achievement of a specific set of goals. The goals may depend on the employee's ability to "make a difference" for the company.

At the simplest, the goal can be simply non-resignation by the employee, as in a "retention" bonus to prevent the employee from leaving before some important transition is completed that will, inevitably, lead to the employee's loss of the current position. In sales, the bonus may be contingent upon achieving a sales target, either individually or for a product or division. In marketing, the bonus may be contingent upon overall marketing metrics such as sales funnel management metrics. In the more complex phase, the goals can be geared to any one of about 30 possible performance metrics of the employer.

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[1] IRC, § 409A(a)(2)(A). The amount distributable in case of "unforeseeable emergency" is limited. It cannot exceed the amounts necessary to satisfy such emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after considering insurance collections.

[2] IRC, § 409A(a)(4)(B).

9. PARACHUTE PAYMENTS UPON CHANGE OF CONTROL

A "parachute payment" is payment of excessive compensation upon a change of control of the employer or substantially all its assets, where the payment exceeds 300% of normal compensation.[1] Excess parachute payments are not tax deductible by the employer. This rule does not apply to S corporations or privately held companies.

10. ABOUT

We hope this information has been enjoyable as well as educational. Bierce & Kenerson, PC has experience in the dealings described to help create and grow your business, as well in strategies for "smarter business exits" to generate liquidity for business owners. We invite your questions. For further information, please contact:

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DISCLAIMER: This information does not constitute legal advice. Consult a lawyer!

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[1] IRC, § 280G.