SELECTED EXECUTIVE COMPENSATION TECHNIQUES

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PREFACE

In today's competitive markets, employers must find ways to attract and retain new talent to their work forces without draining valuable cash reserves. This publication describes several common incentive equity compensation techniques that reward key employees and stimulate business development and growth. Each alternative involves either actual stock ownership compensation, or "phantom" arrangements for cash, options or other distributions which parallel stock performance or increases in company value. Some methods simply measure future compensation to be included in the key employee's income and deducted as compensation paid by the corporation. Others allow key employees to participate in tax-deferred future appreciation of the company's stock and to take advantage of capital gains treatment on sale or disposition of the awarded stock.

Although the benefit of "capital gains" tax treatment has been subject to substantial rate modifications over the years, with many significant tax code revisions adopted by congress since 1986, significant capital gains rate reductions for certain types of property have generally been retained. Potential capital gains tax rate benefits should not be overlooked in considering equity incentive plans. Almost all of the techniques discussed contemplate some income recognition deferral for both regular tax and alternative minimum tax (AMT) purposes.

For purposes of this publication, all examples are for hypothetical Company ("Company") and Employee ("Employee"). The fair market value of Company stock is assumed at $12.50 per share on the date stock options (if any) are issued. The stock value is assumed to increase 40% annually from the date of issue, except as otherwise noted in any particular example.

INTRODUCTION TO EQUITY COMPENSATION

Compensating employees with company ownership has long been recognized as an effective method for stimulating, and rewarding, employee productivity. As the company net worth, and hence stock value, increases, so does the employees "compensation". However, stock or securities transferred to an employee or independent contractor are generally included in the recipient's income and deducted by the corporation in amount(s) equal to the difference between the stock fair market value and any value paid for the stock. For example, an outright transfer of 5,000 Company shares to Employee in a pure stock bonus would result in $62,500 of taxable income to Employee, and a corresponding deduction to Company. The same tax consequences result if Company paid Employee $62,500 in cash compensation or bonus, which moneys Employee then used to purchase Company stock. All of the equity compensation techniques described in this memorandum provide for <u>some</u> preferential tax treatment to either Company, Employee, or both, which makes these incentive plans generally preferred to simple stock bonus awards.

<u>RESTRICTED STOCK</u>

If Company wants to issue stock today, but delay income recognition and deduction to Employee and Company, it could award non-transferable shares subject to "a substantial risk of forfeiture," otherwise known as "restricted stock". Common forfeiture provisions include mandatory repurchase by Company or simple expiration of ownership rights if Employee terminates employment with Company before a specified date, or fails to meet certain predefined sales quotas, revenue targets, etc. If the restrictions are permitted to lapse over time (usually five to ten years), Employee and Company recognize current income and deductions, respectively, in amounts of the fair market value of stock for which restrictions lapse in any given year.

For example, if Company awards 6,000 shares of restricted stock to Employee, of which 2,000 shares become free from restrictions in each of the successive three (3) years, Employee would recognize $25,000 of income during the first year that restrictions lapse if the stock fair market value were $12.50. Employee would recognize $35,000 of income in the second year that restrictions lapsed if the stock fair market value increased to $17.50, and $49,000 in year three if the stock fair market value increased to $24.50. Company would recognize compensation deductions of the same amounts in corresponding years for both tax and financial statement purposes, provided that Company withholds appropriate income tax on such amounts in the proper tax reporting periods.

This arrangement permits the key Employee to acquire stock at no monetary cost, but only if the Employee meets conditions required for vesting, or lapse of restrictions. However, the

Employee will incur income tax liabilities determined by the fair market value of the stock. This may in some cases be a counter-incentive to performance if the employee can meet the minimum required goals for vesting very easily, and the Employee chooses not to maximize performance (and stock value) for purposes of obtaining the shares at the lowest tax cost.

Accordingly, Internal Revenue Code section 83(b) permits Employee to elect to include the entire value of restricted stock shares in income in the year of receipt, irrespective of the lapse and forfeiture provisions. Company would also recognize an equivalent compensation deduction, and be required to withhold appropriate income tax amounts from Employee's salary in the same year. For example, Employee would recognize $105,000 of income in the year of receipt of the stock, regardless of whether the stock was later forfeited due to the stock restrictions, and Company would recognize $105,000 of compensation deduction in the same year. Any subsequent increases in stock value would not be taxed until and unless the shares were later sold, and then at only capital gains tax rates if the applicable holding period requirements were met.

However, under this election, Employee would not be entitled to take a deduction from compensation in the event the stock value declined in any year that restrictions lapsed. Employee would have only long term or short term capital loss treatment for the decline in value in the year of sale or disposition of the stock. Under current rules, Employee may offset other capital gains against capital losses on a dollar for dollar basis, but Employee may only offset other current income in any year by only $3,000 of realized capital loss.

NON-QUALIFIED STOCK OPTIONS

Company may want to grant Employee rights, or "options", to purchase stock at stipulated prices over specified periods of time. Options differ from restricted stock arrangements because Employee must actually pay for the stock. The exercise price of the options is generally equal to the fair market value of the stock at the time the options are granted, so that there is no corresponding bargain element to Employee at the time options are granted. As such, Employee's incentive to perform may be somewhat greater to create value for the purchase options the Employee has acquired than if Employee received Restricted Stock.

Non-qualified stock options can be either vested or unvested; which means the holder may exercise the options as to all shares immediately, or only as specified over time according to a vesting schedule established by Company. Non-qualified stock options may also be transferable if the Company permits. The tax consequences to Employee and to Company of non-qualified stock options are very similar to those of restricted stock. Employee and Company will recognize income and deductions in amounts of the difference between the stock fair market value and the exercise price on the date the option is exercised. Any future appreciation in stock value is taxed as capital gain to Employee upon subsequent sale or disposition.

The holder of non-qualified stock options is not permitted to make an IRC Section 83(b) election. There is therefore no opportunity for the holder to take advantage of possible long-term capital gain treatment on any bargain element of the award. In addition, exercise of non-qualified stock options does not cause any expense to be incurred for financial statement purposes under GAAP principals if the option exercise price is 100% of stock fair market value at the time the option is granted.

INCENTIVE STOCK OPTIONS (ISO)

ISO's were first authorized under the Economic Recovery Act of 1981, as subsequently amended in 1982 and 1986. Incentive Stock Options allow the Company to grant employees rights to purchase stock at a stipulated price over a specified period of time. Except for income tax consequences, ISO's are very similar to non-qualified stock options.

ISO's and non-qualified stock options differ primarily in that the Employee receives preferential income tax treatment upon both the exercise and subsequent sale of ISO stock. The Employee does not recognize income upon exercise of the option, regardless of whether the stock value has appreciated. In addition, the Employee treats all increases in stock value over the exercise price as capital gains upon sale. However, the Company does not receive any compensation deduction for the bargain element of the option upon grant or exercise.

For example, if Company stock is valued at $12.50 per share at the date options are granted, and increases to $24.50 two years later when the options are exercised, the following occurs if the stock is later sold at $30.00 per share:

a) Employee recognizes $17.50 of capital gain upon disposition of the stock ($30.00 sales price less $12.50 exercise price);

b) Company receives no compensation deduction at any time.

For comparison, an Employee receiving non-qualified stock options under the same facts would recognize $12.00 of ordinary income upon exercise of the options ($24.50 stock value less $12.50 exercise price) and $5.50 of capital gains upon sale of the stock. Company would report $12.00 of compensation deduction upon exercise of the options.

To qualify Incentive Stock Options for favorable tax treatment, the Company must comply with certain rules, including:

1. The option grant and exercise price must be equal to the share market price at the date of the grant.

2. The option plan must extend for no more than ten (10) years, and options must be exercised within ten (10) years of the date granted.

3. Stock acquired by option must be held at least one (1) year after exercise and two (2) years after grant before disposition. Failure of this provision will disqualify capital gains treatment to the Employee.

4. Options may not be exercised in amounts exceeding $100,000 per employee per year.

Options are no longer required to be exercised sequentially in the order granted. Employee may therefore exercise options granted at the lowest price, regardless of the date issued, to Employee's best advantage in the event of volatile price movements.

One disadvantage to ISO's issued as unrestricted stock is that the bargain element of the option [which is the difference between the exercise price ($24.50) and the grant price ($12.50)] is a tax preference item to Employee in determining Employee's Alternative Minimum Tax (AMT). The "preference" income upon ISO's issued as restricted stock is the difference between the grant price and the fair market value of the shares acquired on the date the restrictions lapse. "Restrictions" include the Securities Exchange Commission (SEC) rules prohibiting key executives and "insiders" from selling ISO stock prior to six (6) months after the date options are exercised.

CONVERTIBLE DEBENTURES

A convertible debenture is an unsecured debt, or "bond", that can be converted or exchanged for a given number of shares of Company's authorized but unissued common stock. If the debenture has a conversion feature based upon the fair market value of the Company's stock on the date the debenture is sold, there are no tax consequences to the Company or Employee upon conversion. In addition, the Company does not sustain a charge against earnings upon conversion for financial reporting purposes. Of course, these debentures generally don't have a public market, and are generally repurchased only by the issuing company at face value plus any unpaid interest. If the debenture were pledged to a bank, the debenture could be sold from the bank back to the issuing company for the debenture face value upon default of required payments.

Convertible debentures offer the Company and the Employee the following advantages:

1. Assuming no conversion for at least one (1) year after the purchase date, stock received will automatically qualify for long term capital gains treatment to Employee upon receipt under current tax rules.

2. There are no tax consequences to Company or Employee when the debenture is purchased provided the conversion price is at least equal to market price of the conversion shares on the date the debenture is purchased.

3. No withholding tax is due upon conversion.

4. The SEC six (6) month restrictions on key executive and insider trading of shares begins at the date the debenture is purchased, rather than at the date of conversion.

5. Assuming the issuing Company is financially stable, the Employee has no real down-side risk because the Company will repurchase the debenture for its face value prior to conversion, regardless of share price volatility.

6. The debenture is treated as straight debt prior to conversion by the issuing Company for accounting purposes.

7. Large gains may be realized by the Employee if the stock value appreciates significantly over the conversion price after the debenture is purchased.

8. Income tax on stock appreciation is effectively deferred until disposition of the stock acquired by conversion.

The primary drawback to convertible debentures is that the Employee must purchase the debenture at its face amount for cash. The Company could loan the Employee funds to purchase the debenture, and forgive portions of the debt over several years. In such case, the forgiven debt would be taxed as income to the Employee in the year the debt was discharged. The Employee might also obtain financing for the purchase from a third party lender. However, under either case, the Employee would still be liable for the outstanding loan proceeds should the Company become insolvent and default on the obligation.

In addition, certain other SEC rules require that stock held by key executives and insiders may not be disposed of for two (2) years, and the time for purposes of these rules does not begin running until the date of conversion. As such, the Employees ability to react to market swings is effectively restricted.

"PHANTOM STOCK" PLANS" (& STOCK APPRECIATION RIGHTS, OR "SARS")

"Phantom Stock" plans are, in essence, incentive cash bonus plans linked to share price increases. Employer's may use this technique to reward employees for performance that enhances the value of the owner's stock, but does not require the corporation's owners to surrender any ownership to the employees. The employer will normally issue phantom stock "shares" to an employee at the inception of the plan, which have a "certificate value" equal to the market price of the corporate stock at the date of issue. The phantom stock typically does not represent any actual or beneficial ownership of the corporation. Money is not normally paid for this type of phantom stock, and it has no actual cash value in the market place. At the end of the incentive period, the employer will redeem the phantom stock for the current stock price, less the certificate value at the date the phantom stock was issued. If the stock price has increased from the date of issue, a cash amount is paid to the employee. If the stock price declined or did not change, however, the phantom shares are simply surrendered and no cash amount is paid to the employee. Because there is no actual financial cost or loss to the employee if the stock price does not increase, employees may not appreciate the incentive value of this type of plan as fully as with other incentive plans.

Since the phantom stock itself has no value, and its purpose is simply to measure the amount of the cash bonus award to the employee at the redemption date, there generally is no adverse or beneficial income tax consequence to the issue or redemption of the phantom stock. The employee is subject to ordinary income tax on the amount of cash received at the time of redemption, if any, and the corporation receives a compensation deduction for income tax purposes at the date the stock is redeemed or the cash amount is paid, depending on the corporation's income tax accounting method.

In addition, phantom stock plans are not subject to any retirement plan discrimination rules under ERISA or the Internal Revenue Code. However, corporations which have made an election under subchapter "S" of the Internal Revenue Code should usually take special precautions to prevent the phantom stock plan from being deemed a second class of stock and inadvertently terminating the "S" election. The corporation must have sufficient cash reserves, or access to cash, to pay the bonus amount at the date for redemption of the phantom stock. The calculation of the stock value at the redemption period may also be problematic if the corporate stock is not publicly traded, and no ready or identifiable market exists for the stock.

FORMULA PRICE SHARE

The formula price share compensation technique is typically used only by established profitable privately held companies. The objective under this technique is simple: restrict ownership rights inherent in some of the company stock to reduce its value for tax and accounting purposes, making the stock affordable for key employees without affecting the value of other unrestricted company stock. Formula price share techniques are particularly attractive for well capitalized, growth stage companies still in need of equity participation benefits to attract and reward key employees. This technique is generally not useful to start-up companies.

The shares are purchased by key employees at a discounted price from unrestricted stock, but no lapse provisions or "conversion" features are adopted. In essence, the formula price share stock is simply a share of common stock subject to permanent, "non-lapse" restrictions under IRC Section 83(b), discussed above in the section on Restricted Stock. As such, formula price share stock does appreciate in value with other stock to reflect company value, but will always be subject to price discounting due to the permanent restrictions.

Formula price share restrictions might include a permanent right of first refusal requiring the holder to sell the shares back to Company at the formula price discount before selling to any other party. As a result, Company has the option of purchasing back shares under the discount formula (usually a fixed dollar amount discount from fair market value) by exercising its right of first refusal. This prevents the other shareholders stock from being diluted in value at a minimal acquisition cost for the key employee's stock.

For example, assume Company stock is generally valued at $12.50 per share. Company makes stock available to Employee under a fixed "formula discount" of $10.00 per share. As a condition of sale, Employee must first offer stock to Company under the formula discount before selling to any other party.

In year one, Employee can acquire stock for $2.50 per share ($12.50 fair market value less the $10.00 fixed discount). If Company stock value has increased to $17.50 in year two, Employee can acquire additional shares for $7.50 ($17.50 fair market value less $10.00 fixed discount).

If Employee sells stock in year two, Employee must first offer shares to Company at $7.50 per share, which is less than the $17.50 fair market value. Company can exercise the first right of refusal and acquire the stock for the discounted price, in which case Employee realizes gains of $5.00 per share on stock Employee acquired in year one ($7.50 discounted sale price less $2.50 purchase price). If Company does not purchase the stock, Employee can then sell stock to any third party, subject also to the restrictions, at a negotiated market price to reflect the first right of refusal option. Employee's gains would then be equal to the sale price less $2.50 purchase price.

For income tax purposes, Employee recognizes income on the fair market value of the stock, less any purchase price paid, received in connection with the performance of services. Under IRC Section 83(b), income would be recognized in the year the stock is purchased by employee, and the "fair market value" is determined without regard for any restrictions <u>except</u> those which do not lapse. In the above example, Employee's year one income would be the difference between the $2.50 purchase price and the $12.50 fair market value, discounted to reflect required first right of refusal to Company. The fair market value reduction might be less than the full $10.00 per share formula price discount, depending on the facts and circumstances, and the Company's financial ability to actually repurchase the stock. Company would, of course, receive a compensation deduction corresponding to Employee's income.

The formula price share method is not without its risks from an income tax perspective. Although currently there is no <u>contrary</u> authority, Internal Revenue Code statutes and regulations do not specifically address treatment of fixed dollar discounts under IRC Section 83. Fixed dollar discounting is the cornerstone of the formula price share method, and any adverse income tax authority or rulings on this relatively new technique could certainly chill the perceived benefits of this strategy to both key employees and employers. In addition, the formula price discount can not be so large that employees are able to purchase stock with only a "nominal investment" that is disproportionate to the actual value of the stock. Such transactions are routinely set aside by the internal revenue service. In this case, employees would probably be treated for tax purposes as though non-qualified stock options were purchased, plus interest and penalties.

Finally, the Company may also cancel the first right of refusal restrictions and/or the formula share price discount at any time upon proper resolution of the board of directors. Canceling the first refusal rights and formula price discount effectively returns the stock to the same status as all other corporate shares. Of course, the changes in the stock restrictions would cause the employee/shareholder to be taxed on the amount of the canceled formula price discount if the cancellation is deemed compensatory in nature. If the cancellation were <u>not</u> compensatory (i.e. as a necessary fundamental change to capitalization in anticipation of a public offering), the new valuation profits would be taxed to the employee/holder as capital gains income.

RETAINING CONTROL OF YOUR COMPANY

A drawback to adopting an equity compensation plan cited by most owners of closely held businesses is the loss of unrestricted control and the ability to make company decisions enjoyed by the original founder(s). This problem is germane to most equity compensation plans except the phantom stock variety. State statutes and the common law in many jurisdictions impose fiduciary obligations on majority shareholders to look out for the interests of minority shareholders, and some states also require unanimous consent of all shareholders in certain transactions, including the decision to sell a company, substantially all of it's assets, or to wind down and dissolve the business. Minority shareholders are also permitted to bring actions for "partition" in many jurisdictions, effectively forcing a sale or dissolution of a going concern company if the shareholders' cannot agree on fundamental issues concerning their ownership, rights to distributions, or direction of the Company.

A common technique to preserve control over the company in the founding shareholders is to adopt a form of "buy sell" agreement, or unilateral purchase option that allows the company or the founding shareholders to regain the equity shares granted to the key employees, under specific terms and conditions and upon certain triggering events. Another alternative is to issue the equity shares to key employees subject to a "voting trust' arrangement, or irrevocable proxy, whereby voting control of the shares is retained by the Company and/or the original shareholders. Most equity compensation plans can be structured to preserve desired degrees of control in founding shareholders if properly considered and integrated into the plan design before a plan is adopted and rights or interests are granted to key employees or executives.

CONCLUSION AND SUMMARY

This memorandum briefly summarizes and identifies several tax advantaged, equity compensation methods to reward executives and key employees. Each method is unique, and may be appropriate only under special circumstances to give key employees and executives desired additional production incentive. This memorandum is not comprehensive, nor should it be used for any purpose other than as a general reference guide. It is not intended to, and shall not, constitute legal advice. To discuss these techniques, please contact your financial advisors and a competent business planning attorney. They can help you design an equity compensation plan appropriate for your own unique business and employees.