

# EMPLOYEE INCENTIVE PLANNING

WHITE PAPER

**GUYTON  
GROUP**



*Strategies for Your Wealth*

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# Introduction

As business owners plan to exit their businesses, they must confront the challenge of incentivizing employees—specifically, management—to stay with the company after they have left. Having a strong, established, and committed management team to take the reins once an owner has exited is becoming more of a prerequisite than a luxury when selling or transferring the business to a third party. There are several reasons why a strong management team is essential to a successful business exit for owners.

- Before they can sell or exit their businesses with financial security, most owners need to grow their companies' cash flow and transferable value significantly. Without management leading the charge, this can be a monumentally difficult task.
- Few sophisticated buyers will seriously consider acquiring a company without a capable management team that remains with the company after the owner exits.
- More than one-third of business owners plan to sell or transfer their businesses to management, based on *The BEI 2016 Business Owner Survey*.
- Transferring a business to children is especially risky without key employees who will remain with the new ownership.

Each of these observations highlights your need for motivated employees to grow business value and stay with your company after you leave. This white paper describes how you can incentivize key employees to do just that.

The beauty of a well-designed key-employee incentive program is that as your employees meet their incentive-defined goals, you attain your Exit Planning goal of making your company more valuable and marketable (and, of course, it allows you to exit on your terms). Key-employee incentive planning, when executed properly, truly is a win-win for both the owner and his or her employees.

The first task in key-employee incentive planning is to identify exactly who your key employees are. Most of your employees do not fit into the *key* category. Instead, they are motivated by the usual perks of working in a well-run company: a pleasant work environment, a stimulating job, good wages and benefits, and job security.

On the other hand, key employees (who tend to be in management) act and think more like you do. They want more challenges and opportunities. They want to prosper and grow as the company does. In short, they behave like owners. You likely have *key positions* in your organizational chart, so you must make sure that the people filling those slots are *key employees*.

With these guidelines in mind, let's look at how to motivate this small, yet vitally important, group.

## Characteristics of an Incentive Plan

A well-crafted incentive plan does more than just make the owner and employee feel good.

In fact, five criteria are present in a well-designed plan.

1. **The plan provides substantial financial awards to key employees.** In our experience, a potential bonus equal to at least 25% of annual compensation is necessary to motivate an employee to modify performance.
2. **Performance standards are specific.** Employees must successfully perform to determinable performance standards, such as achieving certain company net income or revenue goals.
3. **Performance standards are tied directly to increases in the company's value.** As the key employee achieves measurable objective standards, the company's net income must increase. Unless the company's net income increases, the key employee does not receive a bonus.
4. **Part of the bonus is deferred and subject to vesting.** This characteristic is commonly referred to as "the golden handcuffs." It prevents the employee from severing his or her employment before being fully vested, forcing the employee to forfeit at least part of the deferred compensation if he or she does not stay with the company for a predetermined length.
5. **The plan is communicated in writing to key employees.** Key employees must understand exactly how the plan works for the plan to succeed. The plan must be (a) simple; (b) easy to read; (c) communicated to employees face-to-face, with advisors present to answer any questions; and (d) contain a summary for easy reference.

Having identified the elements that make a successful plan, you and your advisors must determine whether a stock-based or cash-

based plan (or some combination thereof) will best motivate your employees and encourage them to stay with your company after you exit.

## Equity-Based Plans

Providing stock ownership opportunities is one of the most powerful motivational and retention tactics a closely held business can offer to a key employee. Stock ownership motivates key employees for several reasons.

- Stock ties key employees to the company by making them part of the company.
- The plan can require employees to pay for ownership, thus investing themselves, quite literally, in the company. Requiring employees to pay for stock demonstrates their dedication and commitment to the company.
- Stock ownership provides strong incentive to increase business value, as doing so increases the value of the employees' stock.

These are great reasons to transfer stock. However, there are a few negatives to equity-based plans.

It's relatively common for owners to reward an employee with a small percentage of stock because the employee was instrumental in a start-up or is integral to one facet of the company. Unfortunately, these owners fail to appreciate that even the smallest percentage of stock implies significant shareholder rights for the employee.

Shareholders enjoy rights beyond sharing in company growth. They enjoy the right to access company books and records, the right to be informed about the company's financial condition (including your salary and perks), and often a right to be consulted and vote on major company decisions. One possible major company decision is a future sale of the company. You should be fully aware of the voting percentage requirements imposed by law, or by your company's articles or bylaws before unwittingly cornering yourself.

Ownership can change a stock-receiving employee's outlook (usually for the better), and it can change the outlook of his or her coworkers, who now perceive his or her status to have changed. Coworkers may threaten to quit unless they too receive ownership. In attempting to reward a key employee, you may inadvertently antagonize other competent—and potentially key—employees.

If you believe that stock is the appropriate incentive for your key employees, then you must determine when the best time to provide that award is. A decision regarding timeliness is based on the presence of four conditions:

1. Your key employee has been with your company for a sufficient time (usually several years) and has proven his or her worth.
2. The key employee would be more motivated by stock than cash.
3. You are prepared to award the employee a *meaningful* amount of stock. (Should you be unprepared to commit a significant amount of stock ownership to an employee, a stock-based incentive is not appropriate).

4. You are willing to bring the employee into the company's confidence, provide that employee with access to all information regarding the company (including your total compensation), and allow the employee to participate in major decisions concerning the company.

In addition to determining when to award stock, you and your advisors must consider the following:

- How does the incentive plan affect participants in other existing plans?
- Can non-participating employees participate in the future?
- What type of stock (voting or non-voting) will be awarded?
- How much stock will be awarded both at the outset and in the future?
- Which valuation formula will you use when awarding and reacquiring stock?
- When will payments be made?
- What agreement is in place to buy back the stock should the employee leave the company?
- Which performance standard must be attained before the key employee has the right to a stock bonus or purchase?

Assuming that you have determined that a well-designed, stock-based incentive plan will motivate your employees *and* achieve your Exit Objectives, how do you implement it?

## Issuing Stock

Stock can be issued to an employee either through a *non-qualified stock bonus* or by allowing the employee to purchase the stock at either its fair market value or a discounted price.

## Non-Qualified Stock Bonus

With a non-qualified stock bonus, the employee receives stock from the company at no cost. The fair market value of the stock is determined, and the value of that stock is taxable to the employee as ordinary income in the year he or she receives it. The company receives an income tax deduction for the value of the stock bonus to the employee.

Thus, if you decide to have the company issue 100 shares to a key employee, and each share of stock is worth \$500, the employee's taxable income increases by \$50,000, and the corporation deducts \$50,000.

Alternatively, you can install a *restricted stock bonus plan* which, for example, grants the employee \$25,000 worth of stock in the first year and ties the stock to a five-year vesting schedule. Thus, the employee receives all of the economic benefits of owning the full amount of stock upfront (subject only to vesting requirements). If the employee leaves the company prior to full vesting, he or she forfeits part or all of the value.

Finally, the employee has the option to include the full value of the stock awarded in his or her income as compensation in the first year, thus paying a tax only on that amount. Owners often use this type of a restricted plan if the key employee is not using his or her own money to pay for the stock. These plans have significant technical requirements and several design twists, so we recommend that you work with experienced advisors to set up the plan that is right for you and your employees (if necessary, we can help you find those advisors).

## Stock Purchase

Purchasing stock with a cash bonus is another way key employees can acquire stock from the corporation or other key employees (including you). If the stock is purchased at less than fair market value, the employee will have taxable income on the difference between the fair market value of the stock and the price actually paid, and the company will have an offsetting deduction.

## Cash-Based Plans

Most key-employee incentive plans are cash-based rather than ownership-based. While granting ownership is an excellent way to motivate performance, it carries an element of risk, and most key employees prefer cash to stock, unless they have plans to own and run the company. Thus, owners often choose a non-stock incentive plan that provides cash or gives rights to appreciation in stock value rather than the stock itself. There are three primary non-stock (or cash-based) incentive plans:

1. Non-qualified deferred compensation plans.
2. Stock appreciation (SAR) and phantom-stock plans.
3. A blended plan combining current cash bonuses with deferred benefits.

## Non-Qualified Deferred Compensation Plan

Properly designed, the non-qualified deferred compensation (NQDC) plan is often the simplest, most effective, and best method to motivate and retain your key employees. The NQDC plan is a promise to pay benefits in the

future based on a key employee's (or group of employees') current or past services. "Non-qualified" simply means that as long as certain requirements are met, the plan does not have to meet the formal funding, reporting, discrimination, and employee-coverage requirements of the Employee Retirement Income Security Act. In certain situations, the benefits awarded to an employee under an NQDC plan are not taxable until the date on which such benefits are actually paid to the employee (apart from withholding for Medicare and in some cases, FICA taxes).

An NQDC plan includes several important characteristics.

First, it includes a **benefit formula**, which motivates the key employee to increase your company's profitability. Unless the business meets its profitability objective, the key employee cannot meet his or her objective. Therefore, the owner carefully sets the performance standards so that the business' liability to fund the plan exists only when the company is profitable. For example, an owner might decide to make 30% of the company's taxable income in excess of \$100,000 available for bonuses. For a company with \$300,000 in taxable income, the formula would be as follows:

$$\begin{aligned} & \$300,000 - \$100,000 = \$200,000 \times 30\% \\ & = \mathbf{\$60,000} \end{aligned}$$

Using this formula benefits the company because as an employee works to increase his or her reward, the business' income must increase. As business income increases, business value increases by a multiple of the increase in income.

Second, it includes a **vesting schedule**, which "handcuffs" the key employees to the company for a length necessary to become entitled to the benefits that have accrued to them under the benefit formula.

Consider a continual or "rolling" vesting schedule in which a single vesting schedule is applied separately to each year's contribution. Using this schedule, an employee is handcuffed to the company for a long time, because the key employee is never fully vested in the most recent contributions. In our example above, one half of the award (\$30,000) is assigned to a key employee, Sharon, subject to a five-year vesting schedule.

Let's assume that our owner, Mary, has one key employee (Sharon). Mary has determined that she will award half of the bonus (\$30,000) immediately to Sharon in cash or stock and the other half (\$30,000) will be awarded as non-qualified deferred compensation subject to vesting over a select period.

Thus, only in Year 6 is Sharon fully vested in the award earned in Year 1. Should Sharon leave the company prior to that time, she is only entitled to a percentage of the total award amount.

The benefit of continual or rolling vesting to the company is that it financially handcuffs your best employees to your business.

Third, **forfeiture provisions** allow the owner to terminate an employee's otherwise vested rights in benefits under the plan. An employee loses *all* deferred compensation if he or she leaves your company and violates his agreement not to (a) compete; (b) take trade secrets; or (c) take vendors, customers, or company employees.

Forfeiture provisions benefit the company because they provide a powerful incentive for former employees to live up to the promises they made to the company. Be certain to discuss this feature with your business attorney, as state law may restrict your ability to compel forfeiture.

Fourth, **payment schedules** determine when vested payments commence and how long they are to be continued after an employee leaves. A payout over a multiple-year time frame helps the key employee because he or she is taxed on income only as it is received.

The benefit to the company is that payment schedules are usually combined with forfeiture considerations to prevent recently departed employees from using monies from the deferred compensation plan to compete with the owner.

Finally, **funding devices** ensure that cash is available when needed. It is also important for your key employee to know that the funds actually exist (although tax restrictions exist, which may prevent the company from formally funding the plan). Proper investment should be guided by income tax timing considerations. The choice of funding vehicles can influence the timing and amount of income taxes at the company level.

## **Phantom-Stock and Stock Appreciation–Rights Plans**

Like other NQDC plans, phantom-stock and stock appreciation–rights plans include benefit formulas, vesting schedules, forfeiture provisions, and a payment schedules.

## **Phantom-Stock Plan**

In a phantom-stock plan, owners give employees something that looks like stock, grows in value like stock, and can be turned in for cash just like stock, but is not stock. As the employee strives to make the company more valuable, he or she makes his or her interest in the phantom-stock plan more valuable.

Typically, phantom shares corresponding to shares of stock—but not representing actual ownership—are allocated to the participating employees' accounts. As the value of the true stock increases, so does the value of the phantom stock. Any dividends paid on the stock are credited to the employee's account. When the employee terminates his or her employment, the company typically pays him or her the per-share equivalent value of each of the phantom shares vested in his or her account. The amount paid is deductible to the company.

## **Stock Appreciation–Rights Plan**

A stock appreciation–rights (SAR) plan is similar to the phantom-stock plan in that the value of benefits in the SAR plan is tied to the value of the corporation's stock. However, unlike phantom stock, an employee under an SAR plan is only entitled to receive the growth in company value (as represented by the SAR units) beginning on the date of the grant. For example, assume that key employee Sharon is granted a 2% SAR interest equal to 2% of the company's value (say \$1 million). Her 2% SAR value equals \$20,000. When Sharon terminates her employment, she will receive the growth in value of the 2% between the date

of the grant and her departure. When Sharon leaves the company, depending on its design, she may receive her benefit (to the extent vested) in a lump sum upon departure or in a series of payments over several years.

In both phantom-stock and SAR plans, success depends on carefully designing vesting, forfeiture, payment schedules, and funding devices. The benefit formula in both plans is the valuation of the company's stock. Both plans incentivize the key employee to grow company value, just like an owner.

## Conclusion

If you have not yet installed a key-employee incentive plan designed to motivate your employees to increase the value of your company, now is a great time to meet with your advisors. They can talk to you about the IRS regulations that apply to these plans.

We suggest that you use the attached Employee Benefit Checklist to hone in on the important issues in creating employee incentive plans.

If you have installed a plan but find that it is not meeting your objectives, use this white paper to evaluate why it is failing you. Sit down with your Advisor Team, adjust your plans where necessary, and prepare to see the value of your company take off. Of course, you can always contact us today if you need any assistance.

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