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# Family Office Insights

## How family businesses can attract and retain top talent

## Benefits and drawbacks of equity and non-equity compensation

### The challenge

You're running a successful family business or private company. Much of the success has to do with the efforts of one or two key employees, and you want to reward them for both their hard work and the positive results for your enterprise. At the same time, you want to motivate them to continue their exceptional work, build loyalty, and provide an incentive for them to stay with you.

### Stock-based reward solution

A popular approach for this situation is offering stock-based rewards to the key employees. Stock-based rewards can be delivered either in actual shares of stock or in cash. These types of plans allow private companies to attract and retain talent while allowing employees to share in the company's success.

There are a host of different plan design alternatives. Perhaps the largest difference is that with an award of stock, you essentially are giving away some ownership of the company to non-family members, and this can be a major sticking point for privately held companies and family businesses.

**Here are several stock-based plans you may want to consider:**

**Restricted stock:** This is compensation issued in the form of company stock. You often see restricted stock issued in the early stages of a business when the company still has a relatively nominal value or in cases where the goal is to have key employees buy into the business. Once a company grows and significantly increases in value, issuing restricted stock at no cost to the recipients could result in burdensome tax implications.

**Restricted stock units (RSUs):** RSUs represent a promise to the key employees that they will be given a specified number of shares of company stock or cash equivalents once certain "vesting" conditions are met (e.g., reaching specified performance milestones or staying with the company for a certain length of time, or both). However, if the employees leave the company before the specified time or the milestones aren't reached, they receive nothing.

**Phantom stock units:** These are similar to RSUs except that no actual stock is delivered when the "vesting" requirements are met. As with RSUs, if the employee leaves the company before the specified time or the milestones are met, they receive nothing.

Stock options: With stock options, the employee is given the opportunity to purchase a certain amount of stock during a specified period of time at a price set on the grant date. The amount required to buy the stock—called the "exercise price"—generally must be equal to, or greater than, the fair market value (FMV) of the stock on the grant date.

Deciding what type of stock-based award plan to offer to key employees—and the time and/or performance based vesting requirements to impose—is a "facts-and-circumstances" decision that should be tailored to your particular business needs and circumstances. Operating through a partnership structure provides similar opportunities utilizing profits interests. While not exactly the same structure as stock awards, you can accomplish similar goals.

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The following chart highlights the key characteristics of each:

## Comparison of stock-based award plans

| Description | Restricted stock | Restricted stock units (RSUs) | Phantom stock units | Incentive stock options (ISOs) | Nonqualified stock options |
|---|---|---|---|---|---|
| **Type of interest** | Grant of stock, subject to forfeiture unless employee meets vesting conditions | Promise to deliver stock in the future, if vesting conditions are met | Promise to deliver cash, based on stock value, if vesting conditions are met | Option to purchase company stock at a specified price during a specified period of time | Option to purchase company stock at a specified price during a specified period of time |
| **Limit of grant amount** | No | No | No | No more than $100,000 worth of vesting value per year per employee | No |
| **Minimum purchase price** | No minimum | Generally, no purchase price | No purchase price | FMV on grant date | FMV on grant date |
| **Form of distribution** | Stock | Stock | Cash | Stock | Stock |
| **Out-of-pocket cost to employee** | Depends on plan design and whether Section 83(b) election is made[1] | Generally no out-of-pocket cost until stock vests; withholding tax due at vesting | Generally no out-of-pocket cost until unit vests; withholding tax due at vesting | Exercise price paid at time options are exercised; no regular income tax due until shares are sold, but AMT[2] may apply | Exercise price and withholding tax are due at time options are exercised |
| **Tax treatment for employee** | Generally, ordinary income, but Section 83(b) election is available | Ordinary income | Ordinary income | Ordinary income or capital gain, depending on holding period | Ordinary income at exercise |
| **Tax treatment for company** | Ordinary income, if any, is generally deductible | Ordinary income is generally deductible | Ordinary income is generally deductible | Ordinary income, if any, is generally deductible | Ordinary income is generally deductible |
| **Pros** | Potential for capital gain treatment | Flexibility | No transfer of ownership | Potential for capital gain treatment | Flexibility |
| **Cons** | Immediate transfer of ownership | Transfer of ownership (as shares vest) | Cash outflow | More administratively complex | Transfer of ownership (at exercise) |

[1] Sec. 83(b) allows the recipient of the restricted stock to pay tax on the FMV of the restricted stock at the time of the grant. This election typically makes sense when it is likely that the value of the shares is going to increase over time and/or if the income to be reported at the time of the grant is relatively small.
[2] AMT is the alternative minimum tax.

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## What's the right move?

Unfortunately, there is no one "right" answer as to which is the best stock-based compensation approach to adopt. It all depends on your individual facts and circumstances and what you're trying to achieve.

For example, are you trying to tie your key employees' total compensation to company performance? Are you offering them some equity in the company to increase the likelihood that they will stay? What are the cash flow and tax implications of a particular strategy on your company, as well as the key employees?

One thing is for certain, however—consulting with an adviser who focuses on compensation and retirement plans is a must before attempting to implement a stock-based reward plan. Stock-based incentive plans, whether stock or cash based, may be subject to complex rules and regulations (for example, the federal Employee Retirement Income Security Act (ERISA), state and federal securities and tax laws, and Financial Accounting Standards Board (FASB) guidelines). In addition, there is an almost infinite variety of ways to structure these plans to achieve your particular goals.

KPMG professionals provide vast knowledge and practical experience to help you achieve your stock-based compensation and retention goals in a cost- and tax-efficient manner.

**For more information, please visit our Family Offices and Private Client Services webpage.**

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