

Executive Compensation: Comparing Incentives

IPEBLA - April 24, 2012

PAUL
HASTINGS

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 - Related blog: www.executiveloyalty.org

Overview

1. In Search of the Holy Grail
2. Whole Value Awards
3. Appreciation-only Awards
4. Profits Interests and Carried Interests
5. Holdbacks, Clawbacks, and Material Risks

Searching for the Holy Grail

- What tax principles normally apply?
 - taxation of initial award
 - taxation of post-income appreciation
- What is the holy grail re executive compensation?

Stock Award Menu

Basic Alternatives

- Whole-value Awards
 - Restricted Stock
 - Performance Shares
 - Phantom Stock
- Appreciation-only Awards
 - Stock options and SARs
 - Profits Interests
- Cross Border Variations?

Example #1: Common Challenge

- Assume: multi-national employer wants to provide equity-based compensation to its world-wide workforce.
- For employees in Ireland, what are the typical vehicles? any tax favored?
- What about other countries represented by our group?

Ireland - Share Awards - Options

- Historically – options not subject to income tax, social insurance (PRSI) on grant; income tax on exercise; capital gains tax (25%) on subsequent sale if gain
- Finance Act 2011 – significant changes – response to recession in Ireland; extra taxes necessary
- Now – PRSI and USC (Universal Social Charge) applies on grant and income tax on exercise (total up to 52%); capital gains tax (now 30%) on subsequent sale if gain

Ireland – Share Awards – tax advantaged arrangements

- Possible to obtain shares on tax advantaged basis – but limited – must be broad based schemes – open to all employees
- Approved profit sharing schemes (APSS)
 - profits allocated to trust to buy shares for employees
 - shares held for three years
 - no income tax, but PRSI and USC; capital gains tax on disposal
 - max allocation - €12,700 shares p.a.

Ireland – Share Awards – tax advantaged arrangements

- Approved share save schemes (SAYE)
 - after tax share savings arrangement
 - small awards – max saving €6,000 p.a. but PRSI and USC applies
 - savings used to buy shares under option – no income tax if gain
 - minimum three year savings contract with option

Ireland – Other Types of Schemes

- Phantom option schemes
 - income tax, PRSI and USC
- Restricted stock schemes
 - income tax, USC
- Partly paid share schemes
- Growth schemes

Difficulty – fitting US stock plan benefits into new Irish rules

Restricted Stock - Basics

Key Terms

- Nature of Award
 - General Tax Rule
 - Accounting Rules
 - Administration – stock issuance; legend
-
- Main Difference from RSUs
 - See table at back for details

Restricted Stock – Tax and Fin'l

Example:

- Grant Date – 100 shares at FMV = \$2/share
- Vesting – 50% year 1 @ \$5/share
50% year 2 @ \$8/share

Accounting Result? \$___ expense per year

Tax Result:

- Normal Rule: income = \$_____ at _____ (when?)

Performance-based awards

- Performance shares
- Performance units
- Performance-based Amount
- Performance-based Vesting
 - >>> Service-based Vesting
- Example - Microsoft RSU

Example #2: Financial Institution

- Assume multi-national Bank wants to provide restricted stock to its executives.
- For executives in Ireland, what are the regulatory considerations?
 - Different result for stock options? Cash bonus?
- What about other countries represented by our group?

Ireland – Financial Institutions – Stock Awards

- Tax treatment – as before
- CRD III imposes additional requirements
 - applies to credit institutions, investment firms
 - applies to identified staff
 - proportion of pay must be fixed
 - variable component – 40% to 60% must be deferred for three to five years
 - remuneration policies and practices must be in line with prudent risk taking
 - supervised by Central Bank

Appreciation-only Awards

- Stock Options
 - Stock Appreciation Rights
 - Phantom Stock Options
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- Common Tax Rule
 - Financial Accounting Implications

Stock Options – Tax vs. Financial

Example:

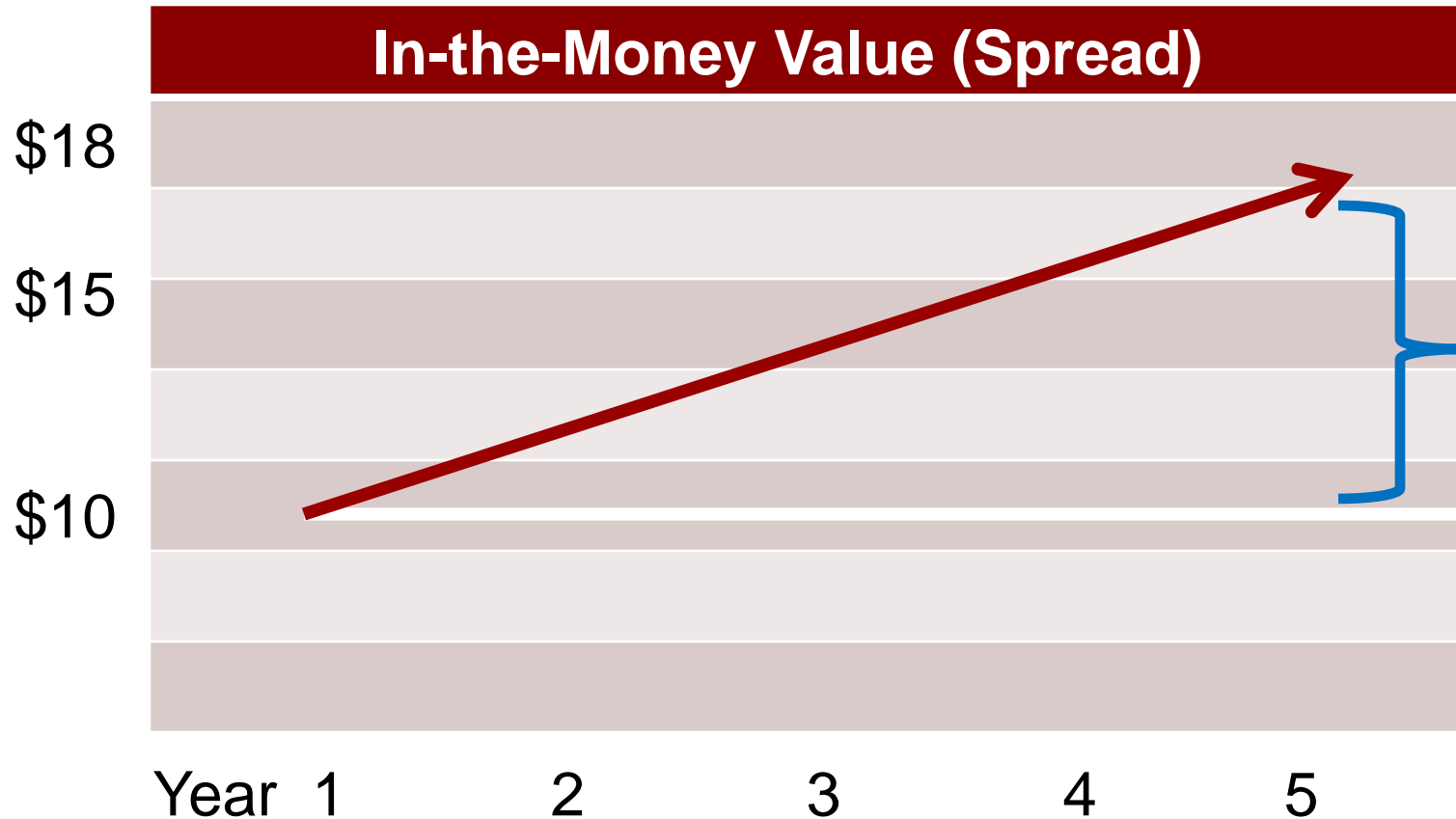
- Grant Date – 100 shares at FMV = \$10/share
- Vesting – 50% year 1; 50% year 2
- Exercise Yr 3 – 100 shares at FMV = \$15/share
- Sale Yr 5 – 100 shares at FMV = \$18/share

Tax Result? Year 3: _____ Year 5: _____

Accounting Result

- Black-Scholes at Grant Date - \$3/share

Stock Options – Financial Picture



Stock Appreciation Rights

Key Terms

- Net Settlement
- Cash vs Shares

Differences from Stock Options

- Tax
- Accounting

Historical Perspective re Little Use

Profits Interests (Carried Interests)

- Partnership Interest Needed?
- Key Attributes
 - Book-ups needed at time of award
 - Tax distributions for imputed income
- Key Limitations
- Carried Interest Alts: waterfall? full sharing?

Profits Interest - Example

- ABC is a partnership, with partners A, B, and C.
- ABC's value is \$3,000, with each partner having a capital account = \$1,000.
- CEO will receive a 10% profits interest.
 - Waterfall: 10% of future profit above \$3,000.
 - Full Sharing: 10% of all future profit.

What per country differences?

Holdbacks vs Clawbacks

- Holdbacks (by vesting) vs. Clawbacks
- Applicable local law – tax and labor
 - Ireland
 - U.S.
 - Others?

Ireland - Holdbacks - Clawbacks

- Generally - Ireland will give effect to contract terms
- Employer discretion – must be exercised reasonably (no other employer would do that)
- Restraint of trade principle – difficult to prove

Major Risk Considerations

Equity Compensation and Cash Incentives:

- Claims by employees vs plan administrators (personal liability?).
 - Labor laws – wages?
 - Privacy laws
 - Securities laws
- Local law re severance benefit levels
- Tax laws re deferred comp and cross-border

Conclusion

>>> Questions?

Restricted Stock vs RSUs

Restricted Stock	RSUs
Unvested shares issued, and then replaced with vested	Only vested shares issued >>> <i>easier administration</i>
Voting of unvested shares	No voting until vesting
U.S. Section 83(b) election allowed	Ineligible for Section 83(b) election
Tax deferral not allowed post-vesting	Tax deferral possible
Dividends paid or reinvested	Same as restricted stock