Executive Compensation: Comparing Incentives

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  Related blog: [www.executiveloyalty.org](http://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
- 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

In-the-Money Value (Spread)

$18
$15
$10

Year 1 2 3 4 5
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

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

Frame 26