

in sights

Mergers & Acquisitions: Affecting Executive Compensation

May 2016

Prepared by:

Executive Benefits Network
833 East Michigan Street | Suite 1480
Milwaukee, WI 53202
Phone 414.431.3999
Fax 414.431.9689
ebn-design.com

EXECUTIVE COMPENSATION AND STOCK OWNERSHIP UPON SALE OF A COMPANY

Mergers and acquisitions have been heating up over the past few years as business valuations continue to rebound and owners look to sell businesses as part of their retirement strategy. When two companies combine to become one entity, there are many executive compensation issues to deal with.

Typically, executive compensation takes the form of:

- Deferred compensation,
- Equity ownership, and
- Quasi-equity ownership

Companies implement executive compensation arrangements to reward and incentivize executives for their performance. One of the key measures of success for executives is to sell the company, either to a strategic buyer, or to a private equity firm.

Upon the sale of the company, many of the executive compensation arrangements that are provided contain provisions that trigger some sort of payment to the executives as compensation for increasing the value of the company.

PLANS TO CONSIDER

1) Deferred Compensation

Unlike equity ownership in a company, nonqualified deferred compensation is a promise to pay a cash bonus in the future. Nonqualified deferred compensation may consist of employee salary or other current compensation that is deferred until a later date, similar to the basic design of a tax-qualified 401(k) plan. It may also consist of employer money, such as bonuses, that is deferred until a later date or structured as a defined benefit plan – similar to a tax-qualified pension plan. There are other arrangements that provide the employee will only be paid with employer money upon certain events in the future, such as a change in control.

“One of the key measures of success for executives is to sell the company, either to a strategic buyer or to a private equity firm.”

Based on the complexity and nuances of IRC § 409A that governs nonqualified deferred compensation, these types of arrangements should be given special consideration when there is or may be an event that would require payment or when termination of assumption of these arrangements is under consideration. If an arrangement does not comport with the requirements of IRC § 409A, the entire value of the plan becomes immediately taxable to the *employee*, there is a 20% penalty imposed on the *employee*, and the employee can be subject to interest and penalties.

HOW IS DEFERRED COMPENSATION TAXED?

Issues that typically arise under these arrangements include when payment is due. IRC § 409A provides for very specific definitions of separation from service, change in control, disability, and others. These strict definitions must be adhered to. For example, separation from service requires the employee to discontinue performing services completely, or if the level of services decreases to less than 20% of the prior level of services over the prior 36 months. If an employee worked an average 40 hours per week and drops to 4 hours per week, this is a separation from service under IRC § 409A. If the plan required payment upon a separation from service, the employee would have to be paid and amounts cannot be deferred any longer to avoid immediate taxation and a 20% penalty and interest.

Nonqualified deferred compensation may be delayed in certain instances. For example, the employee can delay payment if the employee elects to make a re-deferral one year in advance of the original payment date and the payment is made at least five years after the original payment date. Additionally, in change in control situations, there may be circumstances that allow for further deferral if the amounts are "rolled over" and there are additional vesting requirements if amounts were not vested.

A) Phantom Stock

One type of nonqualified deferred compensation that attempts to mirror equity ownership is called **Phantom Stock** (or units if it is an LLC). Under these arrangements, employees receive a right to receive cash in the future based on the value of the stock of the company. For example, if an employee receives a grant of one phantom share, he or she would be paid the value of one actual share of the company upon certain events. However, unlike payments for equity, these payments are taxable as ordinary income to employees.

“IRC § 409A provides for very specific definitions of separation from service, change in control, disability, and others.”

A) Phantom Stock (continued)

Although these arrangements mirror actual stock, they are considered nonqualified deferred compensation subject to the rules under IRC § 409A if amounts are paid more than a short period following vesting. Accordingly, it is a requirement that a document be in place that governs the terms and conditions of the arrangement, including the events that trigger payment and the timing of payment. Typically, these arrangements will be paid upon an employee's termination of employment (either voluntary, involuntary, or both), or upon a change in control. There may also be a "double trigger" requirement that only provides for payment if the employee is terminated from employment by the buying entity following a change in control.

With “Phantom Stock... employees receive a right to receive cash in the future based on the value of the stock of the company.”

B) Change in Control/Severance Agreements

Similar to Phantom Stock arrangements discussed above, change in control or severance agreements for executives are often subject to the rules under IRC § 409A. Accordingly, if these agreements provide for payment upon a change in control, payment must be made to executives unless there is a compliant method to defer the payments until a later time.

“Occasionally, these agreements will not provide for payment upon a change in control.”

Occasionally, these agreements will not provide for payment upon a change in control. Rather, the only payment trigger is separation from service. In these cases, a company may generally terminate all similar deferred compensation agreements and make payment to employees. Without terminating the plan or having a separation from service, such as in a stock transaction, payment may not be made to the employee until a later separation from service with the buying entity. Note, however, that an asset transaction is generally treated as a separation from service that would require payment in these instances.

2) Equity Ownership

A) Restricted Stock

Equity ownership can take various forms. A typical form of equity ownership that is used is called **Restricted Stock**. Restricted Stock is actual stock that is granted to the executive that contain restrictions. For example, the Restricted Stock may not "vest" until a certain time to incentivize executives to continue to provide service.

A) Restricted Stock (continued)

Restricted Stock may also contain restrictions with regard to selling the stock that may require the executive to sell the stock back to the company upon certain events, such as termination from employment. Further, there may be forfeiture provisions that require the executive to give up the stock in certain events, such as termination for cause.

Upon a sale of the company, executives that are granted Restricted Stock will receive a payment for their shares equal to the per share value received by all other shareholders of the company. Restricted Stock that is subject to vesting conditions are also typically accelerated so that the executive will participate in the sale.

To determine the tax treatment for the executives of the cash payment for their shares upon a sale of the company, one must look at the historical events that occurred when the executive received his or her restricted stock. Restricted Stock that is granted with no conditions is taxed at ordinary income rates at the date of the grant. For example, if the stock is worth \$5 per share and the executive received 10 shares with no conditions, the executive would pay tax on \$50 of income as of the date of the grant at ordinary rates. Any gain realized subsequent to the grant would result in income at the realization date at capital gains rates. Using the same example, if the company is sold more than a year later and receives \$12 per share for the sale, the executive would have income of \$7 per share, or \$70, taxed at capital gains rates.

Conversely, if the Restricted Stock contained restrictions such that the executive would forfeit the shares if the conditions are not satisfied, the transfer of shares would not be subject to ordinary income tax until such conditions were satisfied. For example, if the executive had to work for three years until the shares vested, the executive would be taxed once he or she completed three years of service. If the executive vested ratably over three years, the executive would be taxed on the shares that vested each year. The tax would be based on the value of shares at such time he completed three years of service or upon intermittent vesting, which could have increased since the grant date. Any gain from that point would be subject to capital gains rates.

Special Note:

When any form of deferred compensation is accelerated and vesting increases to 100% suddenly, the organization may expense a dramatic increase in the benefit liability and corresponding accrual expense. Acquiring companies should be extremely diligent in analyzing the liability to be sure it is 100% accounted for.

“Upon a sale of the company, executives that are granted Restricted Stock will receive a payment for their shares equal to the per share value received by all other shareholders of the company”

Based on these rules, executives could be taxed at ordinary rates if their shares were not already taxed at the time of the sale. For example, suppose the executive was required to work three years before becoming vested. Suppose that vesting was accelerated upon a sale of the company. In year two, the company is sold. In this case, the shares would become fully vested and the executive would have taxable income at such time of the sale, all of which would be subject to ordinary income rates.

With respect to shares that contain conditions, another wrinkle occurs if the executive makes an "83(b)" election upon the grant. This election is made at the sole discretion of the executive and is almost always made by executives. If the executive makes such election to the IRS within 30 days of grant, the executive elects to incur taxable income at the date of grant based on the value of the shares on the date of grant. In other words, the taxation would be incurred earlier than if no 83(b) election was made and the executive would not incur tax upon subsequent vesting. After making the 83(b) election, any gain from the grant date would be subject to capital gains rates. The catch for the executive is that if the conditions are not satisfied and the executive forfeits the shares, he or she would not receive a deduction for the forfeiture. In other words, the executive would end up paying tax on something he or she would never receive.

Based on the foregoing, to determine the tax consequences of the executives for Restricted Stock, one must first review the terms and conditions of the actual stock grants. These terms and conditions will dictate which executives will receive payment and who will share in the sale proceeds with other shareholders. Once this is determined, the tax consequences could be different for these executives than for other shareholders. The tax consequences will depend on whether the executive already incurred ordinary income tax rates and whether the executive held the stock long enough to receive capital gains treatment.

One final twist may arise if the buyer of the company wants to continue to keep the Restricted Stock in place following the sale. In some cases, the buyer will want the executives to continue working at the new entity to provide continuity of the business. However, in order for the executives to "roll over" their Restricted Stock, the terms and conditions of the grant agreement should be carefully reviewed. Many times executives have a right to receive payment for their Restricted Stock upon a sale of the company. In these cases, the executives would have to specifically agree to avoid receiving a payment and receiving stock in the buying entity, which would require negotiation between the parties. If it is agreed that executives receive stock in the buying entity, the conversion should be a tax-free conversion.

“if the Restricted Stock contained restrictions such that the executive would forfeit the shares if the conditions are not satisfied, the transfer of shares would not be subject to ordinary income tax until such conditions were satisfied.”

“This election is made at the sole discretion of the executive and is almost always made by executives.”

B) Stock Options

Another form of equity compensation is **Stock Options**. An option is a property right that is granted to an executive. The option gives the executive the right to exercise the option and receive a share of stock of the company, which can then be sold at a later time. One key element of a stock option in order to avoid adverse tax consequences is that it should be granted with an exercise price of fair market value at the time of the grant. For example, if the shares of the company are worth \$10, the exercise price of an option should be \$10. If the exercise price were less, for example \$8, the executive has built-in compensation. Under tax laws that govern deferred compensation, a typical stock option with a less than fair market value exercise price would become immediately taxable and subject to a 20% penalty.

Stock options take two forms: **Incentive Stock Options (ISOs)** and **Non-Statutory Stock Options (NSOs)**. Incentive stock options are not taxed upon grant or exercise, and are taxed at capital gains rates upon a subsequent sale. Because of various restrictions for ISOs, companies more typically grant NSOs. NSOs are not taxed at grant, but are subject to tax at ordinary income tax rates upon exercise equal to the value of the share received less the amount paid for such shares. Any gain subsequent to the exercise would be subject to capital gains rates if the shares are held long enough.

Upon a sale of the company, one must review the terms of the stock option grant to determine the payment structure and the tax implications. Options that are not exercised upon a sale of the company could be rolled over and converted into options to purchase the buying entity's stock. If options are rolled over, no additional benefits can be added to the option other than those already contained in the original option. Further, any adjustment to the exercise price or number of options cannot result in the increase of the ratio of the exercise price to the fair market value of the shares upon the conversion. Additionally, the aggregate spread between the exercise price and the fair market value cannot be greater.

If options are not rolled over, they are typically cashed out. Executives who have unexercised options will typically receive a right to receive cash based on the value of their aggregate spread at the time of the sale. In this case or if executives exercise their options close in proximity to the time of the sale, executives will incur taxable income at ordinary rates equal to the aggregate spread.

“...the executive would end up paying tax on something he or she would never receive.”

“...the executives would have to specifically agree to avoid receiving a payment and receiving stock in the buying entity, which would require negotiation between the parties.”

3) 280G Issues

Another area of complexity with regard to executive compensation in connection with a corporate transaction relates to IRC § 280G.

Section 280G of the IRC must be taken into consideration when calculating benefits paid in the event of a change control. When a nonqualified benefit is accelerated and paid out to a participant, the payment must be qualified to determine if it exceeds the Section 280G limit. The limit is equal to three times the average taxable income for the past 5 years.

Example: Taxable Income History	
Year	Taxable Income
2011	\$125,000
2012	\$140,000
2013	\$155,000
2014	\$170,000
2015	\$190,000
Average: \$156,000	
280G Limit: \$468,000 (3x average)	

“When a nonqualified benefit is accelerated and paid out to a participant, the payment must be qualified to determine if it exceeds the Section 280G limit”

If the change of control payment are in excess of the 280G limit, the “Excess Parachute Payments” will be subject to ordinary income taxes PLUS a 20% excise tax. In addition, any payments ARE NOT deductible as an ordinary compensation expense. Careful attention must be given to change of control payments under Section 280G.

4) Nonqualified Plan Financing

If an organization has set aside assets to informally finance the benefit plan liability, it is important to note how the assets will be treated from a taxation basis. EBN published a whitepaper on this topic in 2013 titled “Tax Effects on BOLI and Nonqualified Plans in Bank Mergers & Acquisitions”. The key issue for companies is to understand what happens to the asset in a stock versus asset sale. This topic is beyond the scope of this whitepaper, but should be fully researched by both parties involved in the transaction.

Note: If you have BOLI, there are another set of issues.

CONCLUSION

As the merger and acquisition activity continues to gain momentum, it is critical that both parties involved in the transaction carefully review the forms of equity ownership and deferred compensation programs in place at both entities. Too many times as benefit consultants, we see this topic addressed towards the end of the due diligence only to either cause a rushed analysis of the implications of the merger on these forms of compensation, or the deal going sideways as the parties deal with the unintended tax consequence of the constructive receipt of the compensation. Please consult with your advisors on matters related to equity or deferred compensation before establishing an offer and acquisition price.

ABOUT EXECUTIVE BENEFITS NETWORK (EBN):

As the leading industry advisor, EBN specializes in the customized design, administration, and informal financing of Nonqualified Executive Compensation and Benefit Plans (Deferred Compensation Plans), as well as the procurement of Bank Owned Life Insurance (BOLI) programs to attract, retain, and reward key executive talent. We emphasize the importance of education and build long-lasting relationships with clients in all 50 states, and we have access to the highest rated insurance companies in the nation. Lastly, we believe that no two companies are alike in their needs; therefore, customization of executive benefit and compensation plans is paramount to a successful program.

Executive Benefits Network

833 E. Michigan St. | Suite 1480

Milwaukee, WI 53202

Phone 414.431.3999

Fax 414.431.9689

www.ebn-design.com

The key issues for companies is to understand what happens to the asset in a stock versus asset sale.

ABOUT THE AUTHORS



R. David Fritz Jr., CLU®
Managing Partner
dfritz@ebn-design.com
Office: (414) 431-9688

David is the Co-Founder of Executive Benefits Network and a 32-year veteran of the financial services industry. David is a frequent speaker across the banking industry as an expert in the area of Nonqualified executive benefit plans and Bank Owned Life Insurance programs. David is the Chairman of The American College Foundation, Board member for AALU, Trustee of the Village of River Hills, President of the Milwaukee Country Club and Past-President of the Milwaukee Winter Club Youth Hockey Organization. He is a member of the Indiana Bankers Association, Wisconsin Bankers Association, Bank Holding Company Association, the Society of Financial Service Professionals and the MDRT Association's Court of the Table.



Patrick J. Marget, JD, CPA, CFP®, CLU®
Managing Director
pmarget@ebn-design.com
Office: (414) 431-9681

Pat is a Co-Owner and Managing Director of Executive Benefits Network and a 19-year veteran of the financial services industry. Prior to entering the financial services industry, Pat worked as a senior accountant in audit for KPMG in the bank service area and as an attorney for Michael Best & Friedrich LLP where he concentrated on general corporate and securities law. Pat's career focus is in the BOLI/COLI marketplace, as well designing creative strategies for executive compensation planning, business succession planning and estate planning. Pat is a shareholder and Director of a bank in Iowa and is an active member in the State Bar of Wisconsin. He is a frequent speaker in industry meetings and seminars. He is a member of the Community Bankers of Iowa, Iowa Bankers Association and Wisconsin Bankers Association.

ABOUT THE AUTHORS



Michael W. Taibleson

Attorney

michael.taibleson@jacksonlewis.com

Office: (414) 944-8900

Michael Taibleson is a shareholder and leader of the Employee Benefits Team in Husch Blackwell's Milwaukee office. He offers clients the benefit of his significant experience locally, regionally, nationally and internationally, on behalf of employers, retirement plan fiduciaries, insurers and plan administrators. His work in both law firm and accounting firm environments gives him a unique perspective on the employee benefit design, drafting, negotiating, compliance and fiduciary concerns of clients in the for-profit, non-profit and governmental sectors. IIT Chicago-Kent College of Law, J.D., with honors, 1990; Law Review, Notes & Comments Editor, 1989 and 1990. University of Illinois at Urbana-Champaign, B.S., 1983



David W. Eckhardt

Attorney

David.exkhardt@huschblackwell.com

Office: (414) 978-5414

David Eckhardt is an attorney in Husch Blackwell's Milwaukee office where he is a member of the Employee Benefits and Federal Taxation teams. David focuses his practice on matters related to employee benefits, executive compensation, and taxation. David has extensive experience in executive compensation issues, including compliance of deferred compensation agreements under IRC section 409A, and the structuring and tax treatment of various equity arrangements. David also implements equity compensation plans in partnerships and limited liability companies. He has assisted with executive compensation and employee benefit matters in many corporate transactions. David also focuses on other employee benefit issues, including implementation and operation of qualified retirement plans (including ESOPs), compliance with ERISA, and employment taxes. He further specializes in health and welfare plans, and has given numerous presentations on the Affordable Care Act. David previously worked in the National Tax Department of a Big 4 accounting firm in Chicago. The John Marshall Law School, L.L.M., Taxation, with honors, 2012. The John Marshall Law School, J.D., cum laude, 2009. University of Wisconsin, B.S., Economics, 2006.