

“Cash is as Good as Money,” But What About Stock?

By Dave Jackson

The insurance ad claims that “Cash is as good as money”. Businesses are used to paying employees in cash, but what about giving a key employee company stock instead? Business owners often consider giving employees ownership in the business as an incentive to work harder and smarter, to provide greater upside through return of profits, or to provide compensation when cash flow is low. Before you do so, be aware that using equity as compensation can present significant planning hurdles for employers and employees.

Incentive stock plans and stock option plans are attractive for large employers, particularly where the employer is publicly traded. However, business owners should carefully weigh the benefits of granting equity to employees against the pitfalls of doing so.

For starters, making an employee an owner of a small business typically subjects the owners to fiduciary duties which do not exist with larger companies. Owners of small businesses are subject to fiduciary duties of utmost good faith, loyalty and fair dealing with each other. So, if a family-owned business grants an employee a minority equity position, the family owners are subject to this heightened duty. If the employee-owner disagrees with the management decisions of the majority ownership, the employee-owner may be entitled to inspect the accounting and other financial information of the company, slow down or stop certain company decisions, participate equally in business opportunities of the company under the “corporate opportunity doctrine” and even compel cash payment on the occurrence of certain events such as merger or sale of assets (dissenting owners rights).

And what if the employee quits, is fired, retires, becomes unable to work, is divorced (thereby creating a spousal claim against the stock) or dies? Should the employee be permitted to keep the stock? Typically, employees enter into a buy-sell agreement which gives employers the right to buy back the stock in such cases. If the termination is for cause, the buy-back price often is deeply discounted. Even with such arrangements, the price to repurchase the stock and the terms of such repurchase must be carefully considered, because insurance is not always available to facilitate a buy-back (generally, insurance is only available on death or disability of the employee, and disability buy-out insurance is expensive).

Two viable options include “phantom” equity plans, which mirror the economic results of equity ownership but actually are merely cash bonus arrangements, or plans which give key employees the right to receive amounts upon the sale of the company but which avoid giving the employee actual stock in the company.

Equity received in connection with services rendered is frequently required to be treated as ordinary income to the employee under Section 83 of the Internal Revenue Code. Thus, the employee must claim the fair market value of the equity as income in the year in which it is received. Employees often do not have cash sufficient to pay the tax that will be due on the value of the stock. Transfer of stock granted to employees is typically restricted, and, even if the employee were permitted to sell some of the stock to satisfy the tax liability, it generally is not possible to sell small business stock because there may be no market for it. Even if there were a market, a minority stake in a small business typically is not attractive to investors. Employees need to negotiate for payment of the taxes on receipt of equity, and employers need to be aware of the income and the expense reporting requirements associated with the grant.

Whether you are a business owner or a key employee, the planning considerations for a compensatory grant or receipt of equity in the employer's business present many traps for the unwary. These pitfalls can be expensive and frustrating to deal with if they are not understood and addressed at the outset of the transaction with competent legal and tax counsel. Each situation requires careful consideration of the possible tax implications to both the business and its employees.

For more information on alternative forms of compensation, please contact Dave Jackson or your CPM attorney.