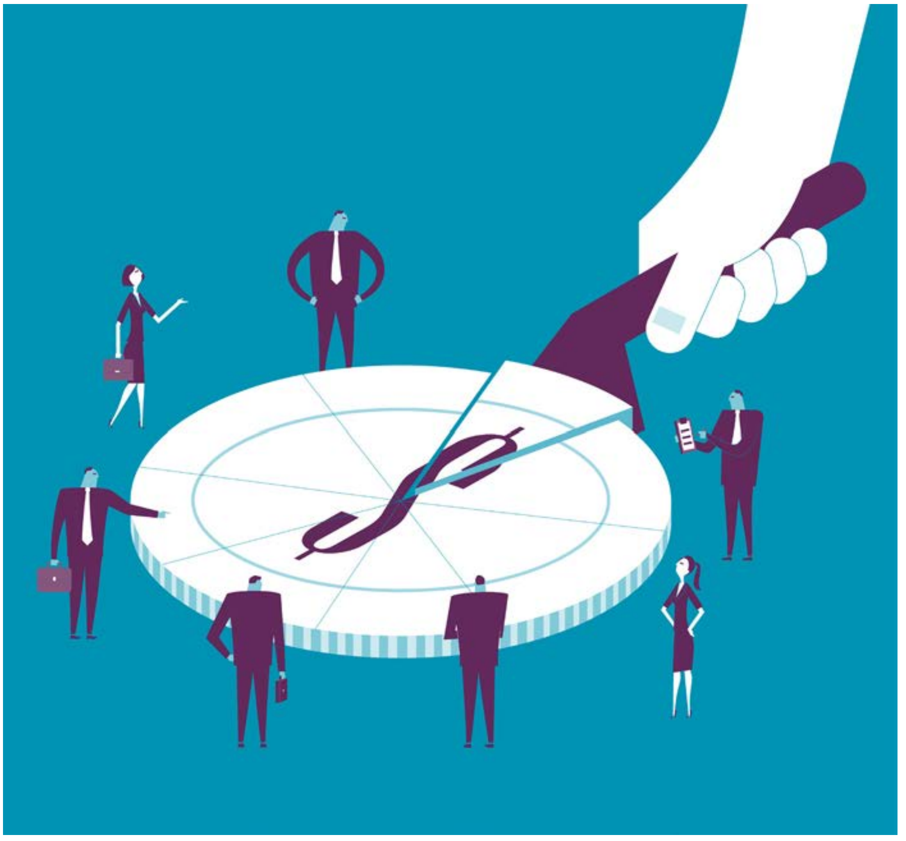
Employee Equity in a Family-Owned Business

Bonus or Profits Payments versus Carried Equity

By Martin Pomeroy



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Family-owned businesses often suffer from a generational lack of leadership. The first generation owner/founder of the business built something from nothing, remains very hands on and typically devoted his or her entire adult life to making the business a success. Sons and daughters are often involved, but day-to-day operations are often delegated to nonfamily executives. These executives are critical to the success of the business – their continued involvement cannot be overstated, and they are often dissatisfied with just a paycheck and no sharing in the "ups."

Equity owners in family-owned businesses are usually relatives. The sweat equity earned by the founder creates an understandable reluctance to give some to someone who came on board when the startup risk is eliminated and who has no blood relation to the founder. How does he satisfy and retain key executives, which preserve the value of the business, while not diluting his own issue's holdings?

A properly structured profits interest grant gives the executive the right to share in the ups, while retaining ownership of the equity wholly within the family. The executive does not own the equity, yet shares in the economic benefits of ownership.

When profits interests are preferred to key executives, the executive thinks he is getting something less and is disappointed. This is where the family's tax and legal advisors can play a pivotal role in preserving the good will associated with the incentive package being preferred to the executive.

A profits interest grant has many advantages over an outright grant of equity. The executive will not be saddled with phantom income, will have no obligation to contribute capital if the business has an unexpected downturn and will avoid additional tax levies, such as self-employment taxes, that are often associated with equity interests. Equity grants may also preclude the employee from being able to take advantage of company's contributions to health and welfare benefit plans, and in particular subsidized health insurance premiums. These issues are complex and time must be taken to carefully discuss them with the executive.

There are negatives regarding a profits interest, such as characterization of income. While family owned businesses cover all disciplines, many involve real estate companies. Real estate companies typically own several properties and dispose of some from time to time. If the executive owned equity, he would recognize capital gain. Gain from a profits interest is typically ordinary income. There are two ways to soften this impact to the executive. One is to create a special class of interest, or carried interest. This may be similar to carried interests granted to promoters in syndicated real estate transactions. However, the characterization of carried interests faces increased scrutiny from Congress, and may soon be changed. Other family concerns include the orderly return of the interest when the executive leaves the company's employ. Properly structured profits interests should immediately revert to the company. Titled equity creates rights, obligations and fiduciary duties from one holder to another that are much higher than in an employer/employee relationship, making recovery more prolonged and expensive. Likewise, concerns associated with an unwelcome party becoming the equity holder in the event of the executive's death, divorce or bankruptcy are minimized.

The second and often preferred way to address the income tax issue is to increase the percentage paid to the executive. Instead of a 5 percent equity interest, he receives a 7 percent profits interest, negating the higher tax rate. The company will receive a deduction for payments made, partially offsetting the increased percentage.

Several other issues that owners must address include: formulas to determine profits; vesting schedules; and repayment terms in the event of the employee's departure and repurchase of his interest. Factors to be considered should include: percentages for cash flow vs. capital events; the founder receives a return on his invested capital; or payments to the executive be subordinate to the founder's invested equity? These should be reflected in a written agreement, which is clear enough to allow two accountants to come to the same answer.

Vesting is always a difficult topic. Vesting should take into account the executive's age, term of service with the company and the minimum continued employment period sought to be preserved. Some plans will utilize "cliff vesting," which is all or nothing once a trigger date is reached. Percentage vesting over time is more common.

Of utmost concern to the executive is what happens upon the occurrence of any of the following events: death; disability; retirement (on or after a certain age) and perhaps discharge of employment, specifically with or without cause. Hypothetically, the employee might be paid an amount equal to a percentage of his previous payments, multiplied by a factor of the number of years of service, obtaining a specified percentage for each year of service. Alternatively, a discounted fair market value could be used, often reflecting a discount of as much as 30 percent for the lack of voting rights and/or control.

What should be clear is that the issues are complex. Use of a profits interest grant, accompanied by thoughtful discussion with key executives, tax and legal advisors and, if appropriate, members of the founder's immediate family, can help insure continuity and preservation of the business for many years to come. ■

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