

**Incentives for Employees**  
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Every business organization, if it intends to become and remain successful, must find a way to motivate employees generally and identify those key employees who can grow and sustain the business. The latter task, involving, as it often does, succession planning, can be the most difficult.

Motivating employees usually takes the form of compensation rewards, either current or longer term such as with retirement plans. Over the years for tax qualified retirement plans Congress has increased the amounts deductible by employers as well as the benefits for employees. In respect to defined contribution plans, such as profit sharing plans, for 2007 employers may contribute and deduct up to 25% of the compensation of participants based upon maximum compensation taken into account of \$225,000. In respect to defined benefit pension plans, the traditional pension/fixed benefit per month plan, the employer can provide up to \$180,000 in annual benefits.

Rewarding key employees should be thought of as a multi-layer process: in the short term compensation and in the longer term, deferred compensation and perhaps even a stake in the business. The critical first step is always to identify the key employees or identify a need and attract a key employee to fill that need.

A publicly held company generally will have a process for identifying, promoting and rewarding key employees.

A closely held business created by one or more dynamic entrepreneurs and owned by several people sometimes within a single family often do not have such processes. Our focus here is on the closely held business.

The problem usually encountered with closely held businesses is that the founding entrepreneur has great difficulty in letting go and grooming successors. If the entrepreneur has a talented family member, a business oriented son or daughter, the immediate problem might appear to be solved. But rarely has this author seen a business successfully carried on by the founder's children without support from non-family key employees. No family can guarantee that talented progeny will be produced in each generation. Retaining and motivating the key employees then becomes crucial if the business is to grow profitably.

Each business organization should determine what aspects of the business are necessary for its success and in what priority. Design, tooling, production, sales and management are typically critical aspects for the manufacturer. Assuming the business organization has filled those spots with capable people, how can these key employees be retained?

Earlier we had mentioned short term and long term layers of rewards for key employees. An employer does not necessarily have to pay the highest rate of compensation for similarly situated key employees. The employer might decide to offer better retirement rewards, or a better current benefit health or deferred compensation or a stake in the business.

Deferred compensation is a means to pay in the future compensation to which the key employee is not currently taxed. At the time the deferred compensation is payable, the employee recognizes income and the employer get a compensation expense deduction. This type of benefit has become a very tricky issue since the advent of Section 409A of the Internal Revenue Code. Unless the deferred compensation benefit is substantially forfeitable and the benefit remains "unfunded", then the employee will be taxed currently and under some circumstances high penalty taxes can become due if an employee should have reported income in an earlier year. The term "unfunded" means that there cannot be any exclusive, untouchable source of funds for the deferred benefit ( as in

the case of a tax qualified retirement plan), and that any funds or accounts segregated for the deferred benefit must always be subject first to the employer's creditors.

Several different types of deferred compensation plans can be engineered for key employees. The plans generally differ only in the way they measure the compensation deferred. For example, a phantom stock plan provides a reward to an employee of a certain number of hypothetical shares of stock. No actual shares are issued and no dilution of ownership occurs for the employer's owners. Rather the phantom stock measures the value of the shares, including dividends which would have been payable if the phantom shares had been issued shares, to be paid at a later time. Stock appreciation rights as deferred compensation measure the rise in value of the company's stock presumably due to the key employee's efforts. At retirement, the cumulative increase in the shares' value is paid to the key employee. These two types of deferred compensation plans would require periodic valuations of the employer which can involve substantial costs.

A simpler type of deferred compensation merely defers a portion of bonus payable. This type of plan can be useful to the employer because it makes the reward to the key employee subject to the discretion of the Board of Directors or president from year to year.

Finally, some thought should be given to transferring ownership interests in the employer to key employees to (i) golden handcuff them to the employer and (ii) provide a means for succession. With proper repurchase agreements the employer can provide a benefit that can keep growing but protect itself from the stock going into unfriendly hands.

There are too many variables in all these types of benefits to discuss here. If you are interested in incentivizing key employees, you should consult your attorneys and advisors.