

OWNERSHIP

VS

NQDC

**for Key
Employees**



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When a construction company owner has assembled a good senior management team, he may begin to consider offering stock to key employees to recognize their contributions to the company and provide a retention incentive to keep the team in place.

BY RICHARD F. SHARPNACK

Perhaps he is nearing retirement and needs buyers for his stock so that he can get some of his stock value out of the company. Traditionally, the owner would make his stock available for purchase to a couple top-level employees; if that goes well, then the majority owner may offer additional stock to other employees.

Sometimes this approach works, and sometimes it does not. What if there is a superstar employee in his 30s or 40s who may be the next leader of the company, but has a big mortgage or college tuition to pay (or save for) and cannot afford to purchase company stock?

In this situation, offering stock for purchase would not make sense unless the company gave the stock away or gave the employee funds to purchase the stock. However, giving stock away would not accomplish the owner's goal of getting a certain value out of the company, and giving the employee funds to purchase stock would mean he has no "skin in the game," with little retention incentive associated with the stock.

In fact, if the stock is not restricted by vesting its ownership or disposition as described by the terms of the buy-sell agreement, then the employee could leave the company and still get the value of this stock.

What options are available other than hoping employees will want to buy the owner's stock? How much retention incentive does stock ownership create? Are there vehicles available other than stock to lock in key employees? What does stock ownership really mean to employees?

This article will answer these questions, compare offering ownership vs. nonqualified deferred compensation (NQDC) to key employees by looking at the advantages and disadvantages of both, and describe situations where offering each option may be the appropriate choice.

Keep in mind that there are three entities involved in any ownership or NQDC situation: an owner (or owners), employees who will be offered ownership or NQDC, and the company. What benefits one or two of these entities may not benefit the others. Thus, a good design for an ownership or NQDC plan balances the advantages and disadvantages for all parties.

CHARACTERISTICS OF OWNERSHIP

Ownership of a construction company can take on many forms, including stock in a C or S corporation or LLC ownership for members of an LLC.

An employee owner actually owns a portion of the corporation with a limited number of rights and privileges, along with a host of liabilities and certain obligations associated with that ownership.¹

Key employees may acquire ownership of a construction company through a number of methods, including:

- Purchasing the ownership with their own funds, company-supplied funds, borrowed funds, or a combination of some or all.
- Receiving ownership as a bonus (e.g., a stock bonus).

- An estate plan (gifted ownership or through a will or trust) if the key employee is a family member.
- Grants from a stock plan, such as a stock option or restricted stock plan.
- An employee stock ownership plan (ESOP) using employee deferrals of compensation or company contributions to accrue ownership in the ESOP trust.

The value of the ownership should be specified through a buy-sell (shareholder) agreement or LLC operating agreement. These agreements also specify how additional ownership may be acquired or disposed of, and what events trigger the disposition of ownership.

Note: Since so few construction companies are structured as partnerships, this article will not cover owning partnership interests. Also, ESOPs will not be covered in detail, since they are separate and distinct ownership plans with complex characteristics and unique advantages and disadvantages.

CHARACTERISTICS OF NQDC

NQDC does not confer any ownership rights to an employee, so an employee with NQDC does not have legal liability like

an owner. However, NQDC can be structured to act like or simulate ownership and is sometimes referred to as “synthetic ownership.”

An NQDC plan is very different from a qualified retirement plan, such as a 401k plan. Exhibit 1 summarizes the key differences between NQDC and qualified retirement plans.

A company creates an NQDC plan and specifies certain key employees as plan participants. These plans are subject to Reg. §1.409A-1. To be eligible to participate in the NQDC plan under ERISA, an employee must belong to a “select group of management or highly compensated employees.”² These plans are often called “top hat” plans, as participation is limited to those in the top positions within a company.

In a typical account balance NQDC plan, participants are granted deferred “contributions” that create a promise for the company to pay these contributions at some future date.

Although grants are called contributions, no funds are set aside for most plans, and making a contribution is simply an accounting entry. The contributions into the plan may be discretionary (i.e., at the discretion of the board) or based on the company’s financial performance

Exhibit 1: Key Differences Between NQDC & Qualified Retirement Plans

| NQDC Plan | Qualified Retirement Plan |
|---|---|
| Subject to a limited number of regulations outlined in the Employee Retirement Income Act of 1974 (ERISA) | Subject to a host of ERISA regulations |
| Contributions are usually “unfunded” to maintain tax-deferred status, unless informally funded by insurance | Plan contributions are funded into a trust |
| Limited number of key employee participants | Broad-based employee participation, except for union employees or those employees with a separate retirement plan |
| May use any vesting schedule associated with paying deferred contributions | Limited to vesting specified in ERISA regulations (maximum of six-year vesting) |
| A liability must be shown on the company balance sheet for future payments of deferred contributions | No balance sheet effects |
| No limits on annual contribution amounts in the plan | Established limits for annual voluntary employee deferrals or company contributions |
| Company or owners receive a tax deduction only when deferred contributions are paid | Company or owners receive a tax deduction in the same year annual contributions are made |
| No statutory age requirements for payment of deferred contributions | Payments may only begin after age 59½ (except for certain hardship situations); otherwise, there may be penalties |



(i.e., performance-based contributions). As long as there is a “substantial risk of forfeiture” (see Reg. §1.409A-1(d)) associated with the contributions, the contributions are tax-deferred until the funds are actually paid to the participants.

There is often a vesting schedule associated with the deferred contributions, and vesting requirements must be satisfied before the deferred contributions are paid.

The requirement to satisfy a vesting schedule, along with a schedule of payments in the future, creates a “golden handcuff” effect (i.e., the requirement that an employee must stay with the company for a certain period of time to receive some or all of the deferred contributions).

NQDC payments may be made in cash or company stock (or LLC ownership). Thus, depending on the vesting and payment terms of the NQDC plan, participants may be paid their deferred contributions with company ownership. Use caution when assessing the tax treatment of NQDC payments made as ownership.

In such situations, a portion of the NQDC payment is typically made as ownership and a portion is made as grossed up cash so that the employee may pay the tax liability on the value of the granted ownership.

The broad area of NQDC encompasses many different types of plans. The following are some types of NQDC plans used by construction companies:

- **Contributory top hat plans** – Contributions or synthetic stock grants are made by the company for the benefit of the key employee participants
 - Equity-based plans
 - > Phantom stock
 - > Stock appreciation rights
 - Account balance plans
 - > Long-term incentives
 - > Performance units
- **Voluntary deferral top hat plans** – Contributions are voluntary deferrals of each participant’s compensation and sometimes the voluntary deferrals are matched by the company
- **Special NQDC plans**
 - Excess benefit plans (similar to an account balance plan, but the amounts contributed are based on a company’s qualified retirement plan)

Stock option and restricted stock plans are hybrids that have characteristics of both NQDC and ownership. Properly structured stock option (both qualified and nonstatutory options) and restricted stock plans are exempt from Reg. §1.409A-1.

Among the requirements for this exemption is that the exercise price at grant of the underlying stock must be fair market value. Discounted stock options (where the exercise price is discounted below fair market value) are subject to the requirements of Reg. §1.409A-1.

Thus, discounted stock option plans are rarely used today and most of these plans have been converted to nondiscounted plans.

ADVANTAGES & DISADVANTAGES OF OWNERSHIP & NQDC

Ownership and NQDC plans each have inherent advantages and disadvantages, as shown in Exhibit 2 on the next page.

Deciding Between Ownership & NQDC for Key Employees

If a majority owner of a small to midsize construction company is considering expanding ownership, limit ownership to a small group of key employees. Spreading ownership to a large group of minority owners creates a number of issues (see Exhibit 2), and the economic benefit for employees with a small amount of ownership is usually limited.

Getting employees to think and act like owners when they own a very small percentage of the total ownership of the company is unrealistic. It is also difficult for some companies to separate ownership and compensation based on position.

Too often, an employee’s salary is elevated beyond what is typical and warranted for his or her position because that employee owns a small amount of company stock.

There are examples of broad-based employee ownership plans outside of an ESOP, usually within large construction companies; however, these plans come with considerable administration costs, either for outside administrative resources or additional staff.

For example, privately held companies that have more than \$10 million in assets and more than 500 owners must file annual Form 10-K reports with the Securities and Exchange Commission.

Exhibit 2: Advantages & Disadvantages of **Ownership & NQDC**

| | Advantages | Disadvantages |
|---|--|--|
| Ownership | Ownership purchases may increase capital in company | Ownership liability for key employee owners |
| | Provides for ownership pay opportunities for key employees | Fiduciary responsibilities for majority owners |
| | Creates a “market” for retiring owners to sell their ownership stake | Additional costs for the company and existing owners |
| | Spreads company risk and indemnification across a larger group | Company financial information must be disclosed to minority owners |
| | Clearly identifies key employees to outside parties | Key employees’ ownership may decline in value |
| | Creates pride of ownership for key employees | Potentially creates unrealistic expectations for compensation and influence on the company from minority owners |
| | Capital appreciation of ownership value is deferred from taxes until sold | Potentially creates organizational upset by differentiating owner and non-owner employees |
| | Increases engagement by recognition of key employees’ value to the organization | Repurchase obligation for the company if an employee owner quits |
| | Reduces uncertainty for the company if majority owner is retiring | Control of company remains with majority owners |
| | Helps to keep ownership of the company in “local” control | Lack of liquidity for privately held company ownership |
| May provide additional funds for key employees’ retirement | Creates partners in the business that may or may not interact well | |
| NQDC | Creates funds for retirement or later in key employees’ careers | Requires a liability to be booked on the company balance sheet for future payments of deferred contributions |
| | May set aside funds for future ownership purchases | Creates an unfunded liability for future payments, unless informally funded by insurance |
| | No ownership liabilities for key employees and no special fiduciary responsibilities of majority owners to minority owners | Potentially creates “haves and have-nots” within the organization |
| | Voluntary deferral plans offer tax deferral of personal earnings | Prevents contributions from being shielded from creditors in a bankruptcy to maintain tax-deferred status of contributions |
| | Creates retention incentives for key employees | Does not allow majority owners of pass-through tax entities to defer taxes on company profits |
| | May reward key employees based on long-term financial performance of the company | |
| | Typically prevents account balance of deferred contributions from decreasing in value if company loses money | |
| | Provides for a compensation reward, in addition to salary and bonus, that is paid later and therefore does not impact short-term cash flow | |
| Allows plan to be terminated at any time and typically returns unvested deferred contributions to the company | | |



Exhibit 3: Preferred Situations for Offering Ownership or NQDC

| Ownership | NQDC |
|---|---|
| Majority owner is retiring and needs buyers for his ownership | Majority owner is not retiring and has no desire to take ownership value out of the company in the near term |
| Selling a company to an outside entity is not the desired option | Ensuring key employee retention with the company is a key |
| Majority owner wants to get some of the value of his ownership (beyond retained earnings) out of the company | Ownership liability or indemnification requirements are “deal killers” for key employees |
| Key employees desire ownership | Majority ownership is held in trusts (family or stock trusts) |
| Key employees are willing to invest their own funds for a portion of the total ownership they will receive | Financial performance of the company (and value of the ownership) is highly volatile |
| Ownership will greatly enhance key employees’ status with customers or other critical third parties | NQDC will be used to set aside funds for future ownership purchases |
| Adding a liability on the company balance sheet for NQDC deferred contributions is not desired due to bonding or banking requirements | Corporate-owned life insurance ³ for key employees is or will be established, and these policies may be used to informally fund NQDC |

Exhibit 3 outlines situations in which offering ownership or NQDC to key employees may be the most appropriate option.

SUMMARY

There are many issues to consider before a company offers ownership or NQDC to key employees. An informed decision should only be made after considering all the facts and circumstances for all parties involved.

The decision between ownership and NQDC does not have to be the same for all key employees; some could be offered ownership and others could be offered NQDC depending on each employee’s unique circumstances. In this case, care should be taken to create equity in the long-term financial benefits of ownership and NQDC, including differences in tax treatment and such other considerations as the inherent risk of company ownership.

If an ownership or NQDC plan is carefully considered and properly structured, then either type of plan may accomplish the parties’ stated goals.

To start this process, realistically state and document the company’s current situation and the goals of the three parties involved – the owners, key employees, and the company. Key decisions may then be made as to whether ownership, NQDC, or a combination of both is the preferred choice. ■

Endnotes:

1. Owners with majority control of privately held corporations have special

fiduciary responsibilities to the owners with minority status. These fiduciary responsibilities vary from state to state, so be sure to check with your local business attorney for more information.

2. 29 USC §1081(a)(3).

3. Corporate-owned life insurance is a life insurance policy on a key employee where the company owns the policy, pays the premiums, and is the beneficiary of death benefits. Cash value in the policy is used to pay NQDC benefits.

RICHARD F. SHARPNACK is President of Sharp Capital Consulting, LLC in Denver, CO, where he provides strategic direction for the company, performs all marketing activities, and works with clients on compensation-related and ownership-transfer consulting engagements.

Previously, Rick served as National Practice Leader – Compensation at FMI Corporation; President of Integrity Engineers and Builders, Inc.; and Director of Engineering and Construction at GEA/Thermal Dynamics.

Rick has published numerous articles in the *Journal of Financial Planning*, *The Contractors Management Journal*, *Journal of Construction Accounting and Taxation*, and *Intermountain Architecture*. Rick is also a member of CFMA and belongs to the Colorado Chapter.

Rick holds a BS from Iowa State University, an MS from Stanford University, and an MBA from the University of Colorado.

Phone: 303-355-0168

E-Mail: rsharpnack@sharpcapitalconsulting.com

Website: www.sharpcapitalconsulting.com