Equity Sharing 101 - Equity vs Profit Sharing

Who Gets a Piece of the Pie?

In our previous article, we discussed various aspects of [profit sharing] as well two different strategies that are commonly used to implement a profit sharing plan for your employees.

That article raised several questions about a different method of sharing the wealth in your company -- **Equity Sharing** – and the differences between the profit sharing and equity sharing models.

Difference Between Equity Sharing and Profit Sharing

What is Profit Sharing

So, what is the difference? While profit sharing can include a position of actual ownership

in a company, typically the profit sharing model does exactly as its name implies; it provides a proportionate share of the "profits" of a company based on a formula created by the company as a benefit to qualified employees.

What is Equity Sharing

On the other hand, equity sharing provides for a share of actual long-term ownership in the company through stock, stock options, membership shares and other equity vehicles. An equity sharing plan often only applies to founders, executive level employees and upper management, although it is not uncommon – and certainly an important consideration -- for a company to provide an equity share model for its employees as well.

It is relatively easy to get excellent technical information about the various equity sharing tools, for example: stock options, stock appreciation, performance shares and restricted stock. It is also a relatively simple task to research general guidelines for equity ownership in publicly traded companies. However, it is a different matter altogether to discover the ins and outs of crafting an equity sharing plan for a startup or closely held company.

Questions About Equity Sharing Plans

How Much Of Your Company Will You Share?
This can be a tricky question. The “typical” approach is to offer a percentage of the stock. Many times that number is randomly chosen at ten percent (10%). Whatever the number, many owners adopt the mindset that there is *some* percentage of the company they are willing to share. However, this can create its own set of challenges. For example, what happens if you distribute your chosen percentage, but then the company expands and you need more equity to share with the your employees. Or what if your chosen percentage turns out to be worth less than you anticipated, so you lose the incentive nature of your equity share plan?

You might consider another approach, for example, distributing ownership shares on a sliding scale based on meeting certain goals or targets. In other words, you would distribute more if key goals are met and a lower amount, or perhaps none at all, if those goals are not met. This model provides an equity position with the extra incentives similar to the profit sharing model.

Who Will Receive Ownership?
It is natural for many owners to consider only “key players” to include in their equity sharing plan. This is certainly a decision that lies solely with the current owners of the company, but one consideration is to think a little “outside-the-box” about equity sharing and treat it in much the same way that you would a profit sharing plan. An example might be to create a program wherein everyone *can* qualify by meeting certain milestones or requirements. We have already established that the profit-sharing model is a strong motivator for employees to think like owners. Offering a similar model that allows them to actually *be* owners could be just the incentive you need to create the growth you want in your company.

How Much Will Each Person Receive?
There are a number of approaches you can take here, including many of those discussed in our previous article on profit sharing, such as time with the company, position held, overall performance and anything else that you choose. Create a model that is big enough to attract, motivate and retain important employees, but also one that is not so large as to create a burden on company assets.

What Type of Equity Will You Choose?
Assuming that you are creating your equity share in a corporation, then your stock options can take two different forms: *non-qualified* and *incentive*. In simplest terms, increase in value of non-qualified equity is taxable as income to employees when they exercise the stock option and deductible to the employer at that time. The incentive model may qualify for capital gains treatment and not be taxed until the sale of the stock, as long as certain rules are met. Using this model, the

employee does not get a deduction and it is possible the employee may have to pay an alternative minimum tax.

Getting More Help – Legal and Accounting Issues
There are numerous issues that need to be addressed prior to implementing your equity sharing plan such as frequency of distribution, deferred compensation issues, non-qualified versus incentive stock options, conditions surrounding restricted stock, stock appreciation rights and all the tax ramifications of these choices to both the employee and the company.

It is important to choose a professional advisor with extensive experience in the area of equity sharing plans. Feel free to Contact us if you have any questions or would like a free quote and consultation.