

Performance Share Fundamentals

Description

Performance shares are performance-contingent pay denominated in common stock and earned over a performance period if certain performance goals are attained. Often, performance share plans provide for a payout matrix under which performance shares are paid at differing levels (e.g., threshold, target, and maximum) based upon achieved performance.

Key Features

Performance Period

Performance period typically is 3 years in duration. Grants are usually made every year as continuing incentive device, which results in overlapping performance periods.

Performance Measures

Performance measures fall into one of the following two categories: (i) performance conditions (e.g., EPS, ROE) or (ii) market conditions (e.g., stock price change or total shareholder return vs. peers)

Payment

If performance goals are satisfied, payment is generally made in shares of company stock (though they may also be settled in cash). The amount of shares earned and paid depends on the performance attained and the related number of performance shares earned.

Shareholder Approval

- **NYSE and NASDAQ listing requirements**—An equity plan under which performance shares may be granted must be approved by shareholders pursuant to stock exchange listing rules. No shareholder approval required if performance shares must be settled in cash.
- **162(m) requirements**—Shareholder approval of the material terms of performance share awards is required for performance shares to qualify as “performance-based” compensation for purposes of IRC Section 162(m) and, therefore, to not be subject to the \$1 million deduction cap applicable to non-performance-based compensation. (Note: Additional requirements must be satisfied for performance shares to qualify as “performance-based” compensation.)

Federal Tax Considerations

To Employee

The following tax consequences assume that performance shares are exempt from IRC Section 409A (see discussion below).

- **At grant.** No tax consequences.
- **At end of performance period.** No tax consequences (unless payment of performance shares coincides with end of performance period).
- **At payment.** The amount received in cash and/or the fair market value of stock received upon settlement of performance shares is taxable as ordinary income.

- **At sale.** If shares received upon settlement of a performance share grant are later sold, then any gain or loss on sale of shares (i.e., post-settlement share price appreciation or depreciation) is taxable as short- or long-term capital gain/loss, depending on how long the shares are held.

To Employer

The following tax consequences assume that performance shares are exempt from IRC Section 409A (see discussion below).

- **Deduction timing and amount.** The employer may take a tax deduction in the amount and at the time the employee realizes ordinary income upon settlement of the performance shares. The tax deduction may be taken for the fiscal year in which the settlement of performance shares is accrued, provided payment is made within 2 ½ months after the end of such fiscal year.
- **162(m) implications.** IRC Section 162(m) denies deduction for compensation in excess of \$1 million paid to CEO and top paid three executive officers (excluding CFO), unless “performance-based” (see discussion above regarding shareholder approval).

409A Considerations

- **Requirements to be exempt from IRC Section 409A.** Generally, performance shares will be exempt from IRC Section 409A if the “short-term deferral rule” is satisfied. The short-term deferral rule is satisfied if performance shares are paid within 2 ½ months after the later of: (i) the end of the employee’s tax year (always calendar year) during which the compensation vested; or (ii) the end of the employer’s tax year during which the performance shares vested. The short-term deferral rule is always satisfied if performance shares are paid upon vesting.
- **Failure to meet exemption requirements.** If a performance share grant is not exempt from IRC Section 409A, then the grant would be subject to 409A substantive requirements. To comply with these requirements, certain plan design features may need to be modified. Failure to comply with these requirements would subject a grant recipient to adverse tax consequences.

Accounting Treatment

Note: The following discussion ignores forfeiture rates and expected tax benefits. In all cases the performance shares are assumed to be subject to satisfaction of either a performance condition or a market condition, as indicated.

Stock-Settled Performance Shares (*performance condition*)

- Each reporting period, the number of performance shares expected to vest is predetermined and the “fair value” of these performance shares is amortized over the remaining requisite period less amounts previously recognized.
- “Fair value” is equal to the number of performance shares expected to be earned (or actually earned) multiplied by the grant date fair market value of a share of company stock.
- At the end of the requisite service period, compensation cost is trued up to equal the “fair value” of the performance shares that actually vest.
- Previously recognized compensation cost for performance shares that did not vest would be reversed.

Stock-Settled Performance Shares (*market condition*)

- The performance shares' grant date "fair value" is amortized over the shares' requisite service period (e.g., typically the performance period).
- "Fair value" may be determined using a Monte Carlo simulation or a binomial model, but generally not Black-Scholes.
- Irrespective of whether the market condition goals have been achieved, any recognized compensation cost may not be reversed after the requisite service period has been rendered.

Cash-Settled Performance Shares (*performance condition*)

- At the end of each reporting period, the number of performance shares expected to vest is re-determined and the "fair value" of these shares would be re-measured (e.g., marked-to-"fair value") and amortized over the remaining requisite service period less amounts previously recognized.
- "Fair value" is equal to the number of performance shares expected to be earned (or actually earned) multiplied by the fair market value of a share of company stock on the date of determination.
- At the end of the performance period, compensation cost is true-up to equal the amount of cash actually paid.
- Previously recognized compensation cost for performance shares that did not vest would be reversed.

Cash-Settled Performance Shares (*market condition*)

- At the end of each reporting period, the performance shares' "fair value" is re-measured (e.g., marked-to-"fair value") and amortized over the remaining requisite service period less amounts previously recognized.
- "Fair value" may be determined using a Monte Carlo simulation or a binomial model but not Black-Scholes.
- Previously recognized compensation cost for performance shares that did not vest would be reversed.

Impact on Earnings per Share

Basic EPS

Nonvested stock-settled performance shares are not included in the computation of the denominator of basic EPS.

Diluted EPS

Nonvested performance shares with a performance or market condition are included in the computation of the denominator of dilutive EPS if the performance shares are dilutive and if their conditions (a) have been satisfied at the reporting date or (b) would have been satisfied if the reporting date was the end of the performance period.