

Performance Unit Fundamentals

Description

Performance units are performance-contingent pay denominated in dollars and earned over a performance period if certain performance goals are attained. Often, performance unit plans provide for a payout matrix under which performance units are earned 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 a 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 cash, though there is no prohibition against settling performance units in stock and some companies do so. The amount of the payment depends on the performance attained and the related number of units earned and the value of each unit which may be fixed or variable.

Shareholder Approval

- **NYSE and NASDAQ listing requirements**—Equity plans under which stock-settled performance units may be granted must be approved by shareholders pursuant to stock exchange listing rules. No shareholder approval required if performance units must be settled in cash.
- **Section 162(m) requirements**—Shareholder approval of material terms of performance unit awards is required for performance units 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 units to qualify as “performance-based” compensation.)

Federal Tax Considerations

To Employee

The following tax consequences assume that performance units 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 units 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 units is taxable as ordinary income.
- **At sale.** If shares received upon settlement of a performance unit 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 have been held.

To Employer

The following tax consequences assume that performance units 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 units. The tax deduction may be taken for the fiscal year in which settlement of performance units is accrued, provided payment is made within 2 ½ months after the end of such fiscal year.
- **Section 162(m) implications.** IRC Section 162(m) denies a deduction for compensation in excess of \$1 million paid to CEO and the top paid three executive officers (excluding the CFO), unless it is “performance-based” (see discussion above regarding shareholder approval).

409A Considerations

- **Requirements to be exempt from IRC Section 409A.** Generally, performance units will be exempt from IRC Section 409A if the “short-term deferral rule” is satisfied. The short-term deferral rule is satisfied if performance units are paid within 2 ½ months after the later of: (i) the end of the employee’s tax year during which the performance units 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 units are paid upon vesting.
- **Failure to meet exemption requirements.** If a performance unit 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 units are assumed to be subject to satisfaction of either a performance condition or a market condition, as indicated.

Cash-Settled, Dollar-Denominated Performance Units (*performance condition*)

Such performance units are accounted for under SFAS 5.

- At the end of each reporting period the number of performance units expected to be earned is re-determined and their value is amortized over the remaining performance period less amounts previously recognized.
- The value of performance units is determined by multiplying the number of applicable units by the fixed dollar value assigned to each unit.
- At the end of the performance period, compensation expense is trued-up to equal the amount of cash actually paid. Any previously recognized compensation cost for performance units that did not vest would be reversed.

Cash-Settled, Dollar-Denominated Performance Units (*market condition*)

Cash-settled performance units that are subject to satisfaction of one or more market conditions are accounted for under SFAS 123R.

- At the end of each reporting period, the “fair value” of the performance units is re-determined (e.g., marked-to-“fair value”) and is 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.
- Previously recognized compensation cost for performance units that did not vest would be reversed.

Stock-Settled, Dollar-Denominated Performance Units (*performance condition*)

Generally, dollar denominated performance units that are settled in stock and subject to a performance condition will be classified as a liability instrument under SFAS 123R and will be accounted for in the following manner:

- At the end of each reporting period, the number of performance units expected to vest is re-determined and the “fair value” of these units 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 units 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 each reporting period after the requisite service period is completed, the performance units’ “fair value” would continue to be re-measured (e.g., marked-to-“fair value”) until settlement and any increase/decrease in the “fair value” would be immediately recognized as a compensation cost or income.
- Previously recognized compensation cost for performance units that did not vest would be reversed.

Stock-Settled, Dollar-Denominated Performance Units (*market condition*)

The performance units’ grant date “fair value” is amortized over the units’ requisite service 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.

Impact on Earnings per Share

Basic EPS

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

Diluted EPS

Nonvested stock-settled performance units with a performance or market condition are included in the computation of the denominator of dilutive EPS if the performance units 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.