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What If?

Create Loyalty, Share The Wealth

Keeping talented employees happy doesn't have to be financially excruciating. Try this strategy.

By Mark C. Minichiello, 11-23-10

Craig Allen Jameson and John Joseph Masotta own Parallax Associates, a growing architecture firm in Culver City, Calif., and they have a problem. The partners want to expand, and they believe that a talented project manager with fresh ideas is just what they need.

"We want to put together an incentive package that would help us attract a talented professional without hurting our ability to grow, to compensate our current employees or take too much from our own pockets," says Jameson.

Parallax has plenty of company. Of the myriad disadvantages small companies face, retaining talent is one of the biggest. The best solutions are the most obvious: Pay rich salaries, share the profits or sharing the ownership. Then again, entrepreneurs don't want to give away their stores. So how to strike the tenuous balance between keeping employees happy and paying them a reasonable rate?

Executive compensation expert Edward Razim, partner at law firm Locke Lord Bissell & Liddell LLP, says that one of the best options for smaller businesses is something called a profits-interest plan. It's a variation on profit-sharing that motivates top performers while letting owners maintain total control of their operations and enjoy some attractive tax benefits. Better yet, profits-interest (also called "carried-interest") plans are relatively simply, says Razim.

In a profits-interest scenario, key employees receive a specified percentage of a company's earnings, not a discretionary bonus, and treat that compensation as ordinary income for tax purposes. Because the payments in a profits-interest plan represent a legitimate compensation expense, owners can charge payouts against earnings to reduce their business tax.

Should a participating employee leave the firm, the unpaid or future profits interest reverts to the company--an important distinction compared with other equity-related compensation schemes.

Here's how a profits interest plan might work: The valuable employee receives a salary, possibly a year-end bonus, and a 0.5% cut of the company's pretax earnings (that's the profits interest). After each year, the employee receives an additional half a percentage point increase of the pretax profits. By the tenth year, he or she would be entitled to a hefty 5% of profits--a powerful incentive to stick around and help make the company as profitable as possible.

Under a stock option or other equity-flavored plan, the same valuable employee would become vested over time--meaning that he leaves your firm for greener pastures and still retains his equity interest. Great deal for the employee, not so much for you and your firm.

This profits-interest strategy isn't for everyone, warns Razim. Startups looking to bootstrap their way to a living need every last dime to pour back into the business. "At the end of the day, it's about the cash: how you measure it and when you pay it," he says.

Razim also notes that nothing lasts forever, including loyalty. Profits-interest payouts will eventually cap out, so consider throwing in a non-compete clause or non-solicitation agreement for good measure. After all, you don't want to have to do battle against your own home-grown talent.

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