Private Company Stock-Based Compensation Arrangements

QR quickreadbuzz.com/2020/02/19/business-valuation-robert-reilly-private-company-stock-based-compensation-arrangements/

National Association of Certified Valuators and Analysts February 20, 2020

To Attract or Retain Key Employees

To both attract and retain key employees, many private companies have added stock-based compensation grants to their portfolio of employee compensation arrangements. An important component of any private company stock-based compensation arrangement is the value of the private company stock. Therefore, private company clients expect valuation analysts to be at least generally familiar with the management considerations related to such stock-based compensation programs. This discussion summarizes some of the basicâ€”but importantâ€”income tax considerations about the compensatory transfer of employer corporation stock. This discussion summarizes both the employerâ€™s and the employeeâ€™s federal income tax considerations related to stock-based compensation arrangements.

Introduction

Due to the current robust economy, many private companies are prospering right now. Therefore, there is competition among private companies in most industries for experienced hires, particularly at the management level. To both attract and retain key employees, many private companies have added stock-based compensation grants to their portfolio of employee compensation arrangements. An important component of any private company stock-based compensation arrangement is the value of the private company stock. Therefore, private company clients expect valuation analysts to be at least generally familiar with the management considerations related to such stock-based compensation programs.

This discussion summarizes some of the basicâ€”but importantâ€”income tax considerations about the compensatory transfer of employer corporation stock. In particular,Â this discussion summarizes both the employerâ€™s and the employeeâ€™s federal income tax considerations related to stock-based compensation arrangements.

Stock-Based Compensation Programs

For most private companies, the typical types of employee stock-based compensation arrangements include the following:

1. Restricted stock awards (RSAs)
2. Restricted stock units (RSUs)
3. Nonqualified stock options (NQSOs)
4. Incentive stock options (ISOs)

Each of these different types of stock-based compensation arrangements is summarized below. And, from the perspective of both the employer and the employee, each of these different types of stock-based compensation programs has both advantages and disadvantages, particularly with regard to income tax issues. Therefore, both the private company employer and the key employee should carefully consider the pros and cons of such compensation arrangements.

Table 1 to this discussion summarizes the income tax consequencesâ€”primarily from the employer companyâ€™s perspectiveâ€”of each of these types of stock-based compensation arrangements.

Table 1: Stock-Based Employee Compensation Arrangements

Federal Income Tax Consequences

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Stock purchase price to the employee	Typically, no payment for the stockâ€"but a payment is not prohibited.	Typically, no payment for the stockâ€"but a payment is not prohibited.	Typically, no payment for the stockâ€"but a payment is not prohibited.	Typically, no payment for the stockâ€"but a payment is not prohibited.
Award exercise price	NA	NA	Must be no less than the employer stock FMV on the grant date in order to avoid Section 409A issues; the exercise price can exceed the employer stock FMV.	Must be at least equal to the employer stock FMV on the grant dateâ€"and at least 110% of the employer stock FMV if the stock is granted to a 10% shareholder.

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Employer company taxation on the grant date	No tax deduction allowed until the shares vest, unless the employee makes a Section 83(b) election. In that case, the employer tax deduction is equal to the FMV of the transferred shares.	No tax deduction allowed if the grant complies with Section 409A. However, if Section 409A is violated, then the FMV of the benefits that are vested as of the employer company tax year-end, less amounts previously taxed, is tax deductible.	No tax deduction allowed if the NQSO exercise price is not less than the employer stock FMV on the grant date. However, if the exercise price is less than the employer stock FMV on the grant date, then Section 409A applies. In that case, the FMV of the benefits that are vested as of the employer company tax year-end, less amounts previously taxed, is tax deductible.	No tax deduction is allowed to the employer.

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Grant vesting date	The tax deduction equals the FMV of the property transferred if no Section 83(b) election is made. However, no tax deduction is allowed if the grant was previously deducted when the Section 83(b) election was made.	No tax deduction allowed to the employer company.	The tax deduction is equal to the then-current MV of the stock, less the exercise price paid, if (1) the vesting date of the employer stock acquired upon exercise is later than the exercise date and (2) a Section 83(b) election was not made at the time of the grant exercise.	No tax deduction is allowed to the employer company.
Grant exercise date	NA	NA	The tax deduction is equal to the then-current FMV of the stock, less the exercise price paid, if the exercise date is the vesting date for the employer stock received in the exercise.	No tax deduction is allowed to the employer company.

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Stock disposition date	No tax deduction allowed to the employer company.	No tax deduction allowed to the employer company.	No tax deduction allowed to the employer company.	No tax deduction allowed if the employee holds the stock for at least (1) one year after the exercise date and (2) two years after the grant date. If the holding period is not satisfied, then the tax deduction is equal to (1) the lesser of the stock FMV on the exercise date or the amount of the disposition proceeds, minus (2) the exercise price paid.

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Stock dividends/ dividend equivalents	If dividends are paid to the holder of an unvested RSA, then the payment is deductible to the employer as employee compensationâ€"instead of being treated as a â€œtrueâ€ dividend.	If rights under the RSU are increased due to the dividends paid before the RSU settlement, then the increase is deductible to the employer upon payout as employee compensation, instead of being treated as a â€œtrue dividend.	Dividends are not typically paid to holders of unexercised stock options. However, if dividend equivalents are paid on the unexercised stock options, then the amount will not be treated as a dividend but would be deductible to the employer as employee compensation.	Dividends are not typically paid to holders of unexercised stock options. However, if dividend equivalents are paid on unexercised stock options, then the amount will not be treated as a dividend but would be deductible to the employer as employee compensation.

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Payroll tax withholding (state and federal income taxes and FICA)	Withholding from the employee compensation is required on the vesting date.	Income tax withholding is required when the amounts are paid to the employee. FICA tax withholding is required when the amounts are vested.	Income tax and FICA tax withholding from employee compensation is required on the exercise date if (1) it is the same date as the vesting date or (2) a Section 83(b) election was made. Payroll tax withholding is required on the vesting date if (1) the vesting date is later than the exercise date and (2) a Section 83(b) election was not made.	Income tax withholding, but not FICA tax withholding, is required on the employee compensation from a disqualifying disposition. Otherwise, no tax withholding is required.

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Section 83(b) election (opportunity for the employee to pay the income tax early)	Available to employee	NA	Available to employee for the stock acquired upon exercise that is subject to a substantial risk of forfeiture (such as vesting).	NA
Section 83(i) election (opportunity for certain employees to defer the income tax payment)	NA	Certain employers can design a stock plan to allow an employee to defer the income tax payment, which will delay the employer companyâ€™s income tax deduction.	Certain employers can design a stock plan to allow the employee to defer the income tax payment, which will delay the employer companyâ€™s income tax deduction.	NA

Â

Restricted Stock Awards

RSAs are actual shares of the private company stock that the employer corporation transfers to the key employee. Typically, the stock transfer is made at no cost to the employee. Such stock transfers are typically made subject to a multiple-year vesting schedule.

When the stock transfer vests, the fair market value of the private company stock is deductible to the employer corporationâ€”on that vesting date. On that same vesting date, the fair market value of the private company stock is reported as W-2 wages to the key employee. Typically, the

employer must withhold from the employee/recipientâ€™s other taxable income both (1) applicable federal, state, and local income taxes and (2) Federal Insurance Contributions Act (FICA) taxes.

However, there are some other withholding options that may be considered. For example, in order to cover the amount of the tax withholding, the employee/recipient may remit cash back to the employer corporation. Alternatively, the employer corporation may withhold some of the newly issued shares of stock with a fair market value equal to the amount of the tax withholding liability.

Often, the key employee may make an Internal Revenue Code (Code) Section 83(b) election related to the RSA. If the key employee makes the Section 83(b) election within 30 days of the RSA grant, then the employee will recognize taxable income immediately on the grant date. That is, the employee does not wait until the vesting period expiresâ€"and until the fair market value of the private company stock has increasedâ€"to recognize the taxable income.

Such a Section 83(b) election may be attractive to the key employee when that employee believes that the private company stock value will increase during the award vesting period. This is because such an election would (1) minimize the employeeâ€™s ordinary income during the vesting period and (2) maximize the employeeâ€™s capital gain when the employer company stock is ultimately sold. However, the key employee should carefully consider the Section 83(b) election. This is because, if the stock grant does not vest or if the value of the employer company stock decreases over time, then the employee cannot obtain a refund of the income taxes paid at the time of the original election.

Restricted Stock Units

An RSU is a promise made by the employer corporation to deliver the private company stock (or cash) to the key employee at some time in the future. The amount of the private company stock delivered is based on the stockâ€™s performance (i.e., value). Since an RSU is not considered to be property for income tax purposes, it is not governed by Section 83. Accordingly, there are no income tax implications when an employer corporation grants an RSU to a key employee.

The grant of an RSU is deferred compensation, taxed under Section 451. An RSU is also potentially subject to penalties under Section 409A. Under Section 451, the employer corporation is allowed a compensation tax deduction when the RSU is actually or constructively paid to the employee. The amount of the employer corporationâ€™s tax deduction is equal to the amount of compensation income recognized by the employee. Typically, this amount is reported to the Service on the employeeâ€™s Form W-2 wage and tax statement.

The employer corporation is required to withhold applicable federal, state, and local income taxes from the RSU payout to the key employee.

Unlike an RSA, an RSU is subject to the Section 312(v)(2) special timing rules for FICA taxes on deferred compensation. If the employerâ€™s RSU program permits, the employer corporation may defer delivering the RSU payment to the key employee until a date after the vesting date.

This RSU payout can be either in shares of company stock or in cash. The key employee may need to make a timely election in order to defer the receipt of the RSU payout.

Both the employer portion and the employee portion of the FICA tax is typically due when the RSU vests. The FICA tax payment is due even if the RSU payment does not occur until a later tax year.

Incentive Stock Options

An ISO award is typically preferred by the employee when the long-term capital gain tax rate is lower than the ordinary income tax rate. This is because (1) no taxable compensation is recognized when the ISO shares are transferred to the employee and (2) 100% of any appreciation in the private company shares is taxed to the employee as a capital gainâ€”when the employee ultimately sells the shares.

For the key employee to receive this favorable income tax treatment, both the employer corporation and the employee must satisfy the numerous requirements included in Sections 421, 422, and 424 (and the related regulations). For the grant to qualify as an ISO, these requirements include (but are not limited to) the following:

1. The option price must at least be equal to the fair market value of the private company shares as of the date of grant.
2. The option must be issued pursuant to a written planâ€”and that plan must be approved by the company shareholders within 12 months before or after the date that the plan is adopted.
3. The grants may only be made to company employees, and the grants must be nontransferable.
4. The option plan term may not exceed 10 years, and the employees must exercise the option within 10 years of the date of grant.
5. The total fair market value of the stock options that first became exercisable is limited to $100,000 in any one calendar year.
6. The employee may not dispose of the ISO shares any sooner than (a) two years after the grant date and (b) one year after the exercise date.

If all these ISO requirements are satisfied, then the employer corporation will never be allowed an income tax deduction for the ISO stock compensation. Alternatively, if any of the ISO requirements are not satisfied, then the ISO is treated as a nonqualified stock option (NQSO).

Upon a â€œdisqualifying dispositionâ€ of an ISO, the following amount will be recognized as compensation income to the employee: (1) the disposition proceedsâ€”up to the amount of the fair market value of the shares on the exercise dateâ€—less (2) the exercise price of the ISO paid by the employee.

The proceeds of the disqualifying disposition in excess of the fair market value of the shares on the exercise date will be taxed to the employee. This amount is taxed as either a long-term gain or a short-term gain, depending on the length of time that the shares are held by the employee

after the exercise.

The employer corporation is allowed an income tax deduction after a disqualifying disposition. The amount of the employerâ€™s tax declaration is equal to the amount of taxable compensation reported as the employeeâ€™s Form W-2. That is, the employerâ€™s tax deduction is contingent on the W-2 reporting of the employeeâ€™s taxable income.

According to Section 421(b), the employer corporation is not required to withhold income taxes on the amount of the taxable compensation caused by the disqualifying disposition of stock that the employee acquired from the exercise of the ISO.

Nonqualified Stock Options

An NQSO is a stock option that does not qualify as an ISO. Generally, the income tax treatment of an NQSO is governed by Section 83 (unless Section 409A applies). To avoid the application of Section 409A, the private company should set the stock option exercise price equal to or greater than the shareâ€™s fair market value on the grant date. A compensatory NQSO typically will not have a readily determinable fair market value on the grant date. Therefore, for income tax purposes, an NQSO is typically not considered to be property on the grant tax. Accordingly, an NQSO is typically not eligible for the Section 83(b) election.

The taxable event is considered to occur when the key employee exercises the NQSO. However, there is a special tax rule that would allow the employee to delay the taxable event beyond the exercise date. If (1) the stock acquired upon the NQSO exercise is subject to a substantial risk of forfeiture and (2) the Section 83(b) election is not made with respect to that stock, then the taxable event is considered to occur when the substantial risk of forfeiture lapses. That is, the stock must be subject to a vesting period. In that case, the taxable event occurs when the stock vests.

If the taxable event occurs on the exercise of the NQSO, then the employer corporation is allowed an ordinary income tax deduction. That tax deduction is equal to the amount of ordinary income recognized by the key employee on the spread between (1) the fair market value of the employer company stock and (2) the stock option exercise price.

The employer corporation is also required to withhold both (1) the applicable federal, state, and local income taxes and (2) the FICA taxâ€”both related to the amount of compensation. The employer corporation also must pay the employerâ€™s portion of the FICA tax.

The taxable event typically occurs when the stock received from the exercise of the NQSO vests. In that case, the employer corporation is allowed an ordinary income tax deduction equal to the amount of taxable income recognized by the employee. That amount is based on the spread between (1) the fair market value of the stock on the vesting date and (2) the stock option exercise price.

The employer corporation is also required to withhold both (1) the applicable federal, state, and local income taxes and (2) the FICA taxâ€"with both related to the amount of the compensation. The employer corporation also has to pay the employerâ€™s portion of the FICA tax.

An Opportunity to Defer the Payment of Taxes

The Tax Cuts and Jobs Act (P.L. 115-97) included a new Section 83(i), related to private companies. Section 83(i) allows an employee of certain private companies to elect to defer the payment of income taxes on certain equity compensation for up to five years. The amount of the income tax owed by the employee is still calculated based on the taxable event and the amount of compensation as described above. However, the payment of the income tax from the employee to the Service is deferred because of the Section 83(i) election.

Of course, the delayed tax payment by the employee will also delay the employer corporationâ€™s income tax deductionâ€"until the year when the employee actually pays the income tax liability. The compensation plans of qualifying employer corporations are not automatically subject to the Section 83(i) income tax deferral rules.

Equity Grants May Be Made to Independent Contractors

So far, this discussion focused on the income tax consequences of compensatory stock awards to the private companyâ€™s key employees. Depending on the industry in which it operates, the private company may also want to make such compensatory equity awards to its independent contractors.

Other than an ISO, all the above-mentioned types of equity grants are also available for award to independent contractors. Instead of reporting on a Form W-2, the tax reporting for independent contractors should be made on Form 1099 MISC, miscellaneous income.

Summary and Conclusion

Due to the robust nature of the economy in many industry sectors, private companies may face competition to attract and retain key employees (and especially experienced executives). Accordingly, such private companies may want to compensate such employees through the grant of company stock. Employer corporations have several different types of compensatory stock-based award arrangements available to them. Each of these types of compensatory stock-based arrangements has advantages and disadvantagesâ€"both to the employer and to the employee. And, private company clients may expect their valuation analysts to be at least generally familiar with the management considerations related to such stock-based compensation arrangements.

This discussion summarized the income tax consequences of four stock-based compensation arrangements that a private company may provide to its key employees. These four types of stock-based compensation arrangements are the following:

1. Restricted stock awards
2. Restricted stock units

3. Nonqualified stock options
4. Incentive stock options

Each of these four types of stock-based compensation arrangements have the same fundamental objective: to provide an incentive level of compensation to attract and/or retain key employees in the private company. However, as indicated in Table 1, each of these types of stock-based compensation arrangements has its own income tax consequencesâ€"both for the employer and for the employee.

When considering what type of stock-based compensation alternative to offer, the private company owner/operators (in consultation with the companyâ€™s professional advisors) should carefully consider the income tax consequences to both the employer corporation and the key employee.

Robert Reilly, CPA, ABV, CFF, CFA, ASA, CVA, CMA, is a managing director of Willamette Management Associates based in Chicago. His practice includes business valuation, forensic analysis, and financial opinion services. Throughout his notable career, Mr. Reilly has performed a diverse assortment of valuation and economic analyses for an array of varying purposes.

Mr. Reilly is a prolific writer and thought leader who can be contacted at (773) 399-4318, or by e-mail to rfreilly@willamette.com.