

Compensating Private Company Key Employees with Stock-Based Compensation Grants

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Many private companies use stock-based compensation arrangements to recruit and retain qualified employees, particularly at the experienced hire and management levels. This discussion summarizes the various types of stock-based compensation plans available to the private company to attract and retain key employees. In particular, this discussion focuses on the income tax considerations (to both the employer company and to the key employee) related to such stock-based compensation arrangements.

INTRODUCTION

Private companies in most industries have to compete with public corporations to attract and retain experienced employees. At these private companies, there is often competition for experienced hires, particularly at the management level. To both attract and retain key employees, many private companies use stock-based compensation grants as a component of their portfolio of employee compensation arrangements.

However, there are various income tax considerations related to stock-based employee compensation awards. These income tax considerations related to stock-based employee compensation grants affect both (1) the private company (i.e., the award grantor) and (2) the individual employee (i.e., the award grantee).

This discussion summarizes some of the basic—but important—income tax considerations with regard to the compensatory transfer of employer corporation stock. This discussion summarizes both the employer’s—and the employee’s—federal income tax considerations related to stock-based compensation.

STOCK-BASED COMPENSATION PROGRAMS

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

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

Each of these different types of employee stock-based awards is summarized below.

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.

The consideration of both the advantages and the disadvantages is particularly relevant 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 programs.

Exhibit 1 to this discussion, which begins on page 85, summarizes the income tax consequences—primarily from the employer company’s perspective—of each of the above-listed types of stock-based compensation arrangements.

RESTRICTED STOCK AWARDS

RSAs are actual shares of the employer corporation stock that the private company transfers to the key employee. Typically, the transfer is made at no cost to the employee. Such 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 corporation—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 has to withhold from the employee/recipient’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, to cover the amount of the tax withholding, the employee/recipient may remit cash back to the employer company.

Alternatively, the employer company 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 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 expires—and until the employer company stock fair market value has increased—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.

The Section 83(b) election is an alternative option. This is because such an election would:

1. minimize the employee’s ordinary income during the vesting period and
2. maximize the employee’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 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 company to deliver the private company stock (or cash) to the key employee at some time in the future. The amount of private company stock delivered is based on the stock’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 company grants an RSU to a key employee.

“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.”

The grant of an RSU is considered to be deferred compensation, taxed under Section 451. An RSU is also potentially subject to penalties under Section 409A. Under Section 451, the employer company is allowed a compensation tax deduction when the RSU is actually or constructively paid to the employee.

The amount of the employer company tax deduction is equal to the amount of compensation income recognized by the employee. Typically,

this amount is reported to the Service on the employee's Form W-2 wage and tax statement.

The employer company 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 employer's RSU program permits, the employer company may defer delivering the RSU payment to the key employee until a date after the vesting date.

This RSU payout can either be in shares of private 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 employee preference is due to the following:

1. No taxable compensation is recognized when the ISO shares are transferred to the employee.
2. 100 percent of any appreciation in the private company shares is taxed to the employee as a capital gain—when the employee ultimately sells the shares.

In order for the key employee to receive this favorable income tax treatment, both the employer

company and the employee have to satisfy the numerous requirements included in Sections 421, 422, and 424 (and the related regulations).

In order for the grant to qualify as an ISO, these requirements include (but are not limited to) the following:

1. The option price must be at least 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 plan—and that plan must be approved by the private company shareholders within 12 months before or after the date that the plan is adopted.
3. The grants are only made to company employees, and the grants are 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 of these ISO requirements are satisfied, then the employer company 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 non-qualified stock option (“NQSO”).

Upon a “disqualifying disposition” of an ISO, the following amount will be recognized as compensation income to the employee: (1) the disposition proceeds—up to the amount of the fair market value of the shares or the exercise date—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 company is entitled to an income tax deduction after a disqualifying disposition. The amount of the employer's tax declaration is equal to the amount of taxable compensation reported on the employee's Form W-2. That is, the employer's

tax deduction is contingent on the W-2 reporting of the employee's taxable income.

According to Section 421(b), employer companies are 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 share's fair market value on the grant date. A compensatory NQSO typically does 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 date. 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.

The taxable event is considered to occur when the substantial risk of forfeiture lapses—that is:

1. the stock acquired upon the NQSO exercise is no longer subject to a substantial risk of forfeiture and
2. the Section 83(b) election is not made with respect to that stock.

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 company 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 stock and
2. the stock option exercise price.

The employer company is also required to withhold:

1. the applicable federal, state, and local income taxes and
2. the FICA tax—both related to the amount of compensation.

The employer company also has to pay the employer company 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 company 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 company is also required to withhold:

1. the applicable federal, state, and local income taxes and
2. the FICA tax—both related to the amount of the compensation.

The employer company also has to pay the employer's portion of the FICA tax.

“When considering what type of stock-based compensation award alternative to offer, the private company owner/operator should carefully consider the income tax consequences to both the employer company and the key employee.”

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 employees 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 company’s income tax deduction—until the year when the employee actually pays the income tax liability.

Plans of qualifying employer companies 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 company’s key employees. The private company may also want to make such compensatory equity awards to its independent contractors.

Other than an ISO, all of 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

Even in times of economic recession, there is often competition among private companies to attract and retain key employees (and especially experienced executives). Accordingly, many private companies in many industries compensate their key employees through the grant of company stock.

Employer companies have several different types of compensatory stock-based award programs available to them. Each of these types of compensatory stock-based arrangements has advantages and disadvantages—both to the employer and to the employee.

This discussion summarized the income tax consequences of four stock-based compensation award 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 programs has 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 Exhibit 1, each of these types of stock-based compensation arrangements has its own income tax consequences—both for the employer and for the employee.

When considering what type of stock-based compensation award alternative to offer, the private company owner/operator should carefully consider the income tax consequences to both the employer company and the key employee.



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Exhibit 1
Private Company Stock-Based 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—but a payment is not prohibited.	Typically no payment—but a payment is not prohibited.	Typically no payment—but a payment is not prohibited.	Typically no payment—but a payment is not prohibited.
Award exercise price	NA`	NA	Must be no less than the employer company 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 company stock FMV on the grant date—and at least 110% of the employer company stock FMV if the stock is granted to a 10% shareholder.
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 company 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 company 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 company.
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 FMV of the stock, less the exercise price paid, if (1) the vesting date of the employer company 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.

Exhibit 1 (continued)
Private Company Stock-Based Compensation Arrangements
Federal Income Tax Consequences

Issue/ Consideration	Restricted Stock Awards (RSAs)	Restricted Stock Units (RSUs)	Nonqualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
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 company stock received in the exercise.	No tax deduction is allowed to the employer company.
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.
Stock dividends/ dividend equivalents	If dividends are paid to the holder of an unvested RSA, then the payment is deductible to the employer company as employee compensation— instead of being treated as a “true” 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 company upon payout as employee compensation, instead of being treated as a “true” 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 company 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 company compensation.

Exhibit 1 (continued)
Private Company Stock-Based Compensation Arrangements
Federal Income Tax Consequences

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.
Section 83(b) election (opportunity for the employee to pay the income tax early)	Available	NA	Available 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 company'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 company's income tax deduction.	NA