Best Practices Discussion

Best Practices Related to Equity Incentive Compensation Programs

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Private companies (and particularly early-stage private companies) may use equity incentives to attract and/or retain talented employees. This employee compensation practice has become more common during periods of labor shortages and low unemployment rates. However, equity incentive compensation plans have income tax consequences—both to the employee recipient and to the employer company. This discussion summarizes the taxation issues and the security valuation issues related to the implementation of private company equity incentive compensation programs.

Introduction

With the labor shortages currently affecting many industries and with the low national unemployment rate, many private companies are considering some form of equity compensation incentives to attract and retain high quality employees. For years, private companies have developed and implemented equity incentive compensation plans for senior executives and for other key employees.

In the current economic environment, many private companies are expanding those equity incentive plans to include all management levels and, in certain cases, some of their rank-and-file employees, as well.

For purposes of this discussion, the term private company includes a corporation (both C corporation and S corporation), a limited liability company ("LLC"), or a partnership. For purposes of this discussion, equity incentive compensation plans include stock (or LLC unit) awards, stock (or LLC unit) options, and partnership profits interests.

With regard to the grant of equity incentives, this discussion considers some of the uncertainties related to the fair market value valuation of private company equity interests. In particular, this discussion considers the compensation related to the valuation of early-stage private company equity interests.

This discussion focuses on both the taxation aspects and the valuation aspects of implementing an equity incentive compensation plan at a private company. In this discussion, the assumed purpose of such a plan is to assist the private company to attract and retain the best employees. This discussion is not intended to provide legal, accounting, or taxation advice.

This discussion focuses on all private companies, including closely held private companies. This discussion is particularly relevant to early-stage and development-stage private companies (including start-up companies). In a competitive labor market, smaller, more thinly capitalized companies may face a greater need to use equity incentive plans to attract and retain high-quality employees.

And, newer, smaller, and more thinly capitalized companies will experience more valuation uncertainty with regard to both the grant and the taxation of their equity incentive alternatives.

Business owners often do not research or consider all of the taxation aspects of implementing an equity incentive compensation plan. The business owner's decision to implement such a compensation plan may have to be made quickly in order to hire or retain a key employee. The taxation considerations of an employment offer that includes equity incentives may be an afterthought.

In addition, the professional valuation of the equity instruments encompassed in the newly created plan may also be an afterthought. The retention of an independent valuation analyst ("analyst") may occur after the equity incentives have been offered—and accepted.

Such analysts may not be familiar with all of the taxation consequences related to the grant of equity incentive awards.

The implementation of an equity incentive plan will have taxation consequences both to the employee recipient and to the private company. These taxation considerations may be particularly material to an early-stage company. Many of these taxation considerations relate directly to the valuation of the equity instruments included in the compensation plan.

Typically, there is a greater level of uncertainty in the valuation of an early-stage private company than there is in the valuation of a larger, established, better-capitalized private company.

This discussion summarizes the least that business owners and analysts—and their tax (and other professional) advisers—need to know about the implementation of an equity incentive compensation plan. Again, the scope of this discussion is limited to stock awards, stock options, and partnership profits interests.

Uncertainty in the Early-Stage Company Valuation

There is some uncertainty with regard to the fair market value valuation of any private company business enterprise. There is greater uncertainty with regard to the valuation of the nonmarketable, noncontrolling equity instruments of a private company.

There is greater uncertainty still with regard to the valuation of the nonmarketable, noncontrolling equity instruments of an early-stage or development-stage private company.

For purposes of this discussion, this uncertainty relates to the probability that the estimated fair market value of the equity will turn out to be different than the actual fair market value of the equity.

For purposes of this discussion, the estimated fair market value is the amount concluded in an independent valuation prepared by a valuation specialist.

For purposes of this discussion, the actual fair market value is the price that is actually paid in an arm's-length transaction between a wiling buyer and a willing seller. This probability that the estimated value is different than the actual value is sometimes referred to as valuation risk.

Valuation risk may be considered as the risk that the independent valuation conclusion will understate or overstate the actual transaction price of a private company equity interest.

Business owners, tax counsel, and other professional advisers should understand that there is some uncertainty—or valuation risk—in every security valuation that is prepared for equity incentive plan purposes. And, there is greater uncertainty—or valuation risk—in every early-stage company security valuation that is prepared for equity incentive plan purposes.

In all private company valuations, analysts exercise professional judgment in the selection and application of the generally accepted business valuation approaches. Analysts exercise professional judgment in the selection and application of the individual business valuation methods applied within each generally accepted valuation approach.

Analysts exercise professional judgment in the selection and application of the specific valuation procedures within each business valuation method. And, analysts apply professional judgment in the selection and application of the quantitative valuation variables (i.e., the actual numbers) that are considered in the selected valuation procedures.

When the subject private company is in its early or development stages, these professional judgements are often more difficult to make and more difficult to support. Often, the analyst's valuation judgments regarding the early-stage company may be difficult to support due to data constraints.

The subject company may not have a long history of financial results of operations. The historical financial results of operations may look materially different year to year—as the subject company matures.

The subject company may not have audited financial statements. The historical financial statements may be influenced by the company's change in accounting policies over time. The historical financial statements may be influenced by the company's debt/equity recapitalizations.

The company may have not yet achieved a stabilized (also called normalized) level of operating income. This lack of stabilized income may limit the analyst's ability to apply the direct capitalization method to the private company security valuation.

In addition, the early-stage company may not have prospective financial statements—that is, financial projections. If the company does have financial projections, the analyst may not be able to assess whether those prospective financial statements are credible.

That is, the analyst may not be able to perform the typical due diligence procedures with regard to those financial projections. For example, due to the company's limited history, the analyst may not be able to compare previous period financial projections to previous period actual results of operations. Such a comparison often allows the analyst to assess management's ability to develop reliable financial projections.

Another valuation data constraint may involve transactional data that would allow the analyst to apply market approach security valuation methods.

For example, there may not be any publicly traded companies that are sufficiently comparable to the subject early-stage company to provide meaningful valuation guidance. In that case, the analyst may not be able to apply the guideline publicly traded company valuation method.

Likewise, there may not be any completed merger and acquisition transactions that are sufficiently comparable to the subject early-stage company to provide meaningful valuation guidance. In that case, the analyst may not be able to apply the guideline merged and acquired company (or guideline transaction) valuation method.

The above-listed data constraints may affect the analyst's judgments with respect to the private company security valuation. There may also be data constraints that affect the analyst's valuation of the options to buy the private company securities.

Many stock option valuation methods involve analyses that are typically called option pricing models. These options pricing models incorporate valuation variables that may also be influenced by the analyst's judgment.

Many option pricing models include consideration of the expected future variability in the private company stock value. And, many option pricing models include consideration of the expected future growth rate (rate of appreciation) in the private company stock value.

However, the analyst may not have adequate data with regard to historical company stock value variability or historical company stock value growth rates. Such data constraints may cause uncertainty in the analyst's private company stock option valuation analyses and conclusions.

Stock Awards and Valuation

Internal Revenue Code Section 83 provides the income recognition rules for an employee's receipt of stock or LLC units (collectively, "stock") with respect to that employee's performance of services.

Section 83(a) provides that the employee's receipt of such stock is taxable income to the extent that (1) the fair market value of the stock exceeds (2) the price (if any) paid for the stock.

The fair market value of the stock is measured at the time that the stock award vests.

Section 83(b) allows the employee to make an election. That election allows the employee to recognize taxable income on the stock grant date, regardless of when the stock award ultimately vests. The amount of the taxable income equals the excess of:

1. the fair market value of the stock over
2. the price (if any) paid for the stock.

When the employee makes the Section 83(b) election, the stock fair market value is estimated without regard to any award restriction that will lapse in the future.

Whether Section 83(a) or 83(b) applies, the amount by which the stock's fair market value exceeds the amount (if any) paid for the stock represents:

1. taxable income to the employee and
2. a tax deduction to the employer company.

If the stock subject to grant is undervalued, then there may be a potential tax liability to the employee. That is, the Internal Revenue Service (the "Service") may claim:

1. the actual fair market value is greater than the amount that was reported by the employee and
2. the employee underreported his or her taxable income.

In addition, if the stock is undervalued, then the employer company will not benefit from the income tax deduction associated with that value understatement.

If the stock subject to the grant is overvalued, then the employee will recognize more taxable income than the Service would have required. In addition, the Service may disallow the employer company's tax deduction for the alleged stock value overstatement.

Stock Options and Valuation

Of course, stock options are typically subject to greater valuation risk than are private company stock awards. This is because, often, there is more analyst judgment involved in the valuation of stock options than there is in the valuation of private company stock.

Nonqualified stock options are more typically granted in private companies (particularly in early-stage companies) than are incentive stock options. This is because nonqualified stock options are generally subject to fewer taxation requirements and restrictions than are incentive stock options.

Unless certain requirements are met, nonqualified stock options may fall within the Section 409A requirements. For purposes of this discussion, the most relevant Section 409A-related taxation requirement is as follows: "the exercise price may never be less than the fair market value of the underlying stock . . . on the date the option is granted." This fair market value requirement is provided in Regulation 1.409A-1(b)5(k)(A)(1).

Section 409A provides for a 20 percent additional tax (plus interest) on the amounts to which it is applied. Therefore, taxpayers (and their tax advisers) want to make sure that any stock options are issued with a strike price at or above the fair market value of the employer company's stock.

In the *Sutardja* decision,[1] the Service applied the provisions of Section 409A to discontinued stock options. The Service claimed that the taxpayer's exercise of the employer company's stock option was from a nonqualified deferred compensation plan under Section 409A(d).

Dr. Sehat Sutardja and his wife Weili Dei were employed by his company, Marvell Technology Group Limited. Dr. Sutardja exercised a stock option that was granted by Marvell. Upon audit, the Service applied the additional 20 percent tax provided by Section 409A(a)(1)(B)(i)(II). At trial before the Court of Federal Claims, both the taxpayer, Dr. Sutardja, and the Service agreed that the stock option did have a readily determinable fair market value as of the grant date. Based on that agreement, the taxpayer could not convince the court that the nonqualified stock option was not issued at a strike price below fair market value.

Partnership Profits Interests and Valuation

Many private companies operate as either a C corporation or an S corporation. In recent years, many early-stage companies have elected the LLC form of organization. These LLCs typically elect to be taxed as partnerships. Currently, the Biden administration has proposed the return of higher federal income tax rates for C corporations. In the event that such a fiscal policy initiative can make its way through Congress and be passed into law, the LLC organization structure may become even more popular—particularly for start-up companies.

Like early-stage corporations, early-stage LLCs often use equity incentive plans to attract and retain talented employees. For LLCs (taxed as partnerships), one possible compensation alternative is profits interests. In such a compensation arrangement, the employee becomes a partner of the firm—but a partner who can only share in the future appreciation of the company. Revenue Procedures 2001-43 and 93-27 provide safe harbor provisions under which the Service will treat the employee's receipt of a partnership profits interest as a nontaxable event.

In Revenue Procedure 93-27, the Service defined a partnership profits interest as any "partnership interest other than a capital interest." At its grant date, a partnership capital interest "would give the holder a share if the proceeds of the partnership's assets were sold at fair market value." Therefore, the fair market value valuation of the profits interest is an important consideration.

The safe harbor provisions in the above-mentioned revenue procedures only apply in instances that the Service considers to be a true profits interest. The question of what provisions qualify as a partnership profits interest has been litigated. See, for example, *Crescent Holdings, LLC*.[2] If the partnership interest is issued "in the money," then the Service may recast the profits interest as a capital interest. The grant of a capital interest would be considered taxable compensation to the employee on the grant date. In other words, the Service will treat the grant of a capital interest just like the grant of a stock (or an LLC unit) award.

Such a Service challenge to a partnership profits interest is particularly important to an employee who has made the Section 83(b) election. In that situation, if the Service recasts the profits interest as a capital interest, then the employee will have to recognize taxable income equal to the fair market value of the (recast) capital interest on the grant date.

Valuation Challenges

When business owners implement any of the above-mentioned equity incentive programs, tax counsel and other advisers often recommend that the company retain specialist professionals to estimate the fair market value of the employer company and of the subject equity interests. These specialists prepare these fair market value security valuations as of a specifically identified valuation date. That date is typically the equity incentive grant date. Such security valuations are typically prepared by analysts with specialized valuation credentials. And, such security valuations are typically developed in compliance with generally accepted valuation professional standards.

Nonetheless, as discussed above, such security valuations are influenced by the individual analyst's professional judgments. And, such analyst judgment is influenced by the company, industry, economic, and capital market information that is known or knowable to the analyst as of the specified valuation date.

When the Service reviews the company's equity incentive compensation program years after the fact, the Service has the benefit of hindsight. Particularly for an early-stage private company, the actual company results, competitive conditions, and economic trends may turn out differently from what was projected by the company management or by the valuation analyst.

This sometimes-called hindsight advantage often affects the Service's challenge of security valuations prepared for income tax, estate tax, or gift tax purposes. In the *Estate of Jung*,[3] the Tax Court opined that "if a prospective . . . buyer and seller were likely to have foreseen [a future sale], and the other activities leading to the liquidation, then those later-occurring events could affect what a willing buyer would pay and what a willing seller would demand as of [the valuation date]."

In other words, the courts sometimes agree that the Service can consider certain post-valuation-date events to assess the credibility of an independent valuation analysis. The question is typically disputed about whether such post-valuation-date events were actively known—or could have been knowable—as of the specific valuation date.

The possibility of this hindsight lookback on the part of the Service may influence how the employer company approaches the valuation of the equity ownership interest. Business owners are typically advised not to undervalue the equity incentive award if there may be a near-term stock sale, company sale, or company capitalization event that will provide the Service with post-valuation-date security pricing benchmarks.

Of course, for private companies, valuation uncertainty—or valuation risk—cannot be eliminated entirely. This conclusion is particularly true in the case of an early-stage or development-stage company.

As discussed above, such security valuations—however professionally prepared—are often influenced by the limited availability of both historical data and prospective data. Of course, the business owner's reliance on a professional analyst's independent valuation helps the taxpayers to comply with various Section 409A safe harbors. And, such reliance—and such safe harbors—shift the burden of proof on any equity incentive valuation challenges from the taxpayer to the Service.

With a professionally supported equity interest valuation in place, the business owner can more confidentially use the equity incentive compensation plan to attract and retain talented employees.

Making the Section 83(b) Election

The Section 83(b) election is an employee election, not an employer company election. First, the employee receives from the employer company one of the equity incentives described above. Second, the employee makes the Section 83(b) election. This election allows the employee to recognize the income tax consequences of the equity incentive at the time of the incentive grant—rather than at the time that the equity incentive is vested.

Presumably, for a successful employer company with an appreciating equity value, the amount of compensation income that the employee will have to recognize is much lower on the current grant date than it will be on the future vesting date.

More generous private companies may pay for a tax adviser (or some other expert) to advise the employee recipient regarding the decision to make the Section 83(b) election. The principal purpose of implementing an equity incentive compensation plan is to attract and return talented employees.

The business owners want to keep the company's best employees happy. Company employees who are faced with unfavorable or unexpected income tax consequences—or who missed an opportunity to enjoy a favorable income tax treatment—generally will not be happy employees.

The *Alves* Decision

The Tax Court's decision in *Alves*[4] illustrates the negative consequences of an employee not making a timely Section 83(b) election with regard to an equity incentive award. In this case, the taxpayer was an employee of an early-stage private company, General Digital Corporation.

The employee, Lawrence Alves, was granted the right to company common stock at 10 cents per share, the then fair market value of the stock. In fact, employee Mr. Alves purchased the stock for a price equal to fair market value. Upon audit, the Service never challenged the fair market value pricing determination.

The issue is that the employee still owned the stock at the end of the vesting period, and the private company stock had appreciated materially between the grant date and the vesting date. In the year of the vesting date, the employee did not report that appreciation as compensation income on his income tax return.

The Service audited Lawrence Alves. The Service issued an adjustment and assessed additional tax on the amount of the stock value appreciation between the purchase date and the vesting date. Again, employee Alves had paid an undisputed fair market value price for the new corporation's stock on the grant date.

But, Mr. Alves did not make the Section 83(b) election. Therefore, the Service claimed that the stock value appreciation was ordinary income to the employee under Section 83(a).

Alves brought suit in the Tax Court. Based on these facts, the Tax Court agreed with the Service. In its decision, the Tax Court stated "it is unfortunate that the petitioner did not elect the provisions of Section 93(b)." However, the court upheld the Service's position.

Lawrence Alves appealed to the U.S. Court of Appeals. In its decision in *Alves*,[5] the Ninth Circuit upheld the Tax Court's decision. The Appeals Court also noted how unfortunate this result was for the taxpayer employee.

The Appeals Court stated, "the tax laws often make an affirmative election necessary. Section 83(b) is but one example of a provision requiring taxpayers to act or suffer less attractive tax consequences." While the Ninth Circuit recognized how inequitable this result may seem to Mr. Alves, this court also upheld the Service's position.

In the *Alves* matter, if the taxpayer had simply made the Section 83(b) election, he would have escaped the taxation on ordinary income related to the General Digital Corporation stock appreciation between the purchase date and the vesting date.

In addition, in this case, there would have been no tax cost to Mr. Alves to make the Section 83(b) election. This is because, at the time of the early-stage company stock purchase, the "excess" of the stock's fair market value over the stock's purchase price was zero. This would have been the result because Mr. Alves had paid the full fair market value for the General Digital Corporation stock.

Other Section 83(b) Election Issues

It is noteworthy that making the Section 83(b) election also starts the statutory clock running with regard to any Service challenge to the equity incentive transaction. That is, the tax year in which the employee makes the election starts the statutory limit on the amount of time during which the Service can challenge the valuation of the equity incentive award.

Both grants and awards subject to vesting provide the Service with several opportunities to challenge the valuation of the equity incentive. The Service can challenge the initial equity valuation and any subsequent equity valuations during the various vesting dates.

Therefore, it may be in the employee's interest to make an election that begins to limit the time period during which the Service can challenge the equity valuations.

Employee recipients (and employer companies) should be aware that there is some financial risk to making the Section 83(b) election. The risk is that the employee may ultimately forfeit the equity incentive award or grant after the election is made.

Employees (and employers) should realize that the private company shares (or the LLC units) often are not legally vested when the election is made. Those shares (or units) typically can be forfeited if the employee leaves the employer company for any reason before vesting occurs.

Section 83(b)(1) states the following: "if such election is made . . . and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture."

That is, if the employee leaves the employer company and forfeits the equity incentive, the employee will not get a tax deduction for the grant date income that was recognized at the time the Section 83(b) election was made.

Employee (and employers) should note that forfeiting the equity incentive stock (or units) has different income tax consequences than disposing (say, in a liquidation) of the stock (or units). In a disposal (say, liquidation) scenario, the employee will have a tax basis in the stock (or the units) that are being disposed.

This tax basis was created when the employee made the Section 83(b) election and recognized taxable income at that time. If the liquidation proceeds (if any) are less than the employee's basis in the shares or units, then the employee can claim a capital loss on the disposal of the equity interest.

The point is that there are both risks and rewards to the employee recipient who makes the Section 83(b) election. The previous paragraphs illustrated a couple of the risks. However, employee recipients (and employer companies) should consider that the rewards of the election generally outweigh the risks of the election.

If the private company is successful, then the employee could expect that the stock or units will appreciate over time. And, the employee would expect to ultimately sell the stock or units (whether back to the employer company or to another buyer) at a price much higher than the price the employee originally paid for the equity interest.

If the employee had made a valid Section 83(b) election, then all of that appreciation would have been taxed as a long-term capital gain—rather than as ordinary income.

Summary and Conclusion

Business owners (whether of early-stage companies or seasoned companies) are often in competition to attract and retain talented employees. This statement is particularly true when the national (or industry) unemployment rate is at a historically low level. And, this statement is particularly true when the better employees believe that it may be a good time to jump ship and find (what they perceive to be) a better opportunity.

Early-stage and development-stage companies may find it more difficult to recruit the most talented employees. Rightly or wrongly, such employees may perceive more risk and less opportunities associated with smaller employer companies.

In order to incentivize and retain high quality employees (and, particularly, key position employees), many private companies offer a variety of equity incentive compensation programs.

This discussion considered stock grants, stock options, and partnership profits interests as three typical examples of such compensation programs. These types of equity incentive programs are fairly typical in early-stage and development-stage companies.

Employees in such companies often believe that they deserve such equity incentives. Such employees often remind the business owners that "they came in on the ground floor" and that "they helped the company to achieve its success." In such situations, these employees sometimes believe that they have earned a share of the company's value appreciation.

In addition to compensation advisers, business owners should consult with tax advisers and valuation specialists before implementing an equity incentive compensation program. Such programs bring income tax consequences to both the employee recipients and to the employer company.

Valuation specialists should be aware of such consequences and should be aware of how their fair market value security valuations may affect those consequences.

In particular, all parties to an equity incentive program should be aware of the uncertainty associated with the valuation of private company securities—and particularly early-stage company securities.

The parties should understand that the Service is less subject to this so-called valuation risk when it challenges these private company security valuations. That is because the Service may be applying hindsight when it reviews such transactions years after the grant date or the vesting date.

Business owners should consider all of the taxation consequences of implementing an equity incentive program. Business owners should also consider the practical consequences of implementing such a program.

For example, if the company employee does not have the available liquidity to exercise a stock option or to pay the income tax on a stock award, then such a program could prove to be an employee disincentive rather than an employee incentive.

Finally, both employees and employers should consider the costs and the benefits of all of the tax elections—and other tax strategies—related to the equity incentive compensation awards.

Notes:

1. Sutardja v. United States, 109 Fed.Cl. 358 (2013).
2. Crescent Holdings, LLC v. Commissioner, 141 T.C. 477 (2013).
3. Estate of Jung v. Commissioner, 101 T.C. 412 (1993).
4. Alves v. Commissioner of Internal Revenue, 79 T.C. 864 (1982).
5. Alves v. Commissioner of Internal Revenue, 734 F.2d 428 (9th Cir., 1984).

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