FOUR TAX SECTIONS TO CONSIDER WHEN STRUCTURING EQUITY COMPENSATION

Stock option plans and other forms of equity-based compensation allow startups and emerging growth companies to incentivize employees to continue working with the company to achieve certain milestones. These forms of compensation often trigger complex tax issues. The consequences of noncompliance with the tax code in structuring these compensation plans can undermine the intended benefit of the equity award. For example, when an employee is granted a stock option it can be taxed at the capital gains rate if it is held for the required holding period but these options are sometimes exercised early and result in the stock option being taxed at a higher rate. Further, a defective equity award may result in an additional twenty percent penalty tax and interest payments.

The following is a list of four common questions we receive from clients in connection with structuring equity compensation arrangements.

WHAT CAN I DO TO LIMIT MY TAX BURDEN IF I RECEIVE RESTRICTED STOCK?

When a company grants restricted stock to an employee or a service provider and include certain vesting requirements with the stock, the grant often triggers section 83 of the Internal Revenue Code ("IRC"). Under Section 83 of the IRC any individual who receives property, in this case restricted stock, in connection with the performance of services must recognize ordinary income equal to:

The excess of the fair market value of the property when the rights to the property first become either: (i) transferable; or (ii) no longer subject to substantial risk of forfeiture.

Employees or service providers who receive company stock may be subject to a higher tax rate if they wait until their restricted stock vests before claiming a taxable event. We advise our clients to mitigate their tax burden by making a Section 83(b) election. When you make an 83(b) election the property becomes taxable on the day it is granted and not

KEY ISSUES

- Making an 83(b) election within 30 days of receiving restricted stock can mitigate tax consequences
- Deferred compensation must comply with Section 409A or risk adverse tax consequences
- A grant of incentive stock options must comply with Section 422 of the Tax Code.
- A public company may deduct more than $1 million for covered employees by following three steps for a Section 162(m) exemption

CONTACT

For further information on the subjects covered in this memo or our services, please contact:

RICARDO O'NEIL BERNARD
Managing Partner, R. Bernard Law Group
rbernard@rbernardllp.com
T: +33 (0) 7 60 97 41 11
T: +1 (646) 475 1398

when it vests. To be effective, an 83(b) election must be filed with the IRS within 30 days of purchasing the shares. Once the 83(b) election is made there will be no U.S. federal income tax consequences when the equity vests. Also, if the employee or service provider sells or disposes of the equity in a taxable transaction, any appreciation in the value of the equity since the taxpayer made the 83(b) election will be taxed as capital gain, rather than ordinary income. Finally, the taxpayer's holding period will start from the date the equity was received, so if the equity is held for longer than one year after it is received, any gain realized in a sale will be taxed as long-term capital gain.

ARE THERE ANY SPECIAL CONSIDERATIONS ASSOCIATED WITH DEFERRED COMPENSATION?

Any deferred compensation plan should be in compliance with Section 409A of the IRC. Section 409A regulates the taxation of nonqualified deferred compensation and covers "service providers" which may be employees or independent contractors.
The penalties for noncompliance under Section 409A are imposed on the service provider and not the employer. Deferred compensation plans that fail to comply with Section 409A may result in (i) the deferred compensation being included in income when it vests; (ii) a twenty percent tax penalty; or (iii) increased interest rate on the late payment of income tax due on the compensation. Noncompliance therefore subjects the employee to a greater tax burden and, by extension, a reduction in the amount of compensation initially thought to be deferred.

HOW CAN WE STRUCTURE OUR INCENTIVE STOCK OPTIONS TO COMPLY WITH THE TAX CODE?

Incentive stock options ("ISOs") can sometimes provide employees with more favorable tax treatment than non-qualified stock options. ISOs must comply with Section 422 of the IRC and are not subject to regular tax treatment if they are held for both (i) one year from the exercise date; and (ii) two years from the grant date. The employee incurs no income tax on the grant date or on the exercise of the ISO but profits, if any, would be taxed as long-term capital gain.

To qualify as an ISO the option must, among other things, be:

- for the purchase of stock of the employer or an affiliate thereof;
- granted in connection with the person's employment for the corporation; and
- granted within ten years of the earlier of: (i) the plan adoption date; or (ii) the date the plan was approved by shareholders.

Common pitfalls in ISO grants that disqualify the option include permitting the employee to pay the option exercise price with previously acquired shares of the corporation or allowing the ISO holder to receive additional compensation when the option is exercised if such compensation would trigger Section 61 or 83 of the IRC.

WE ARE A PUBLIC COMPANY, IS THERE A SECTION OF THE TAX CODE WE SHOULD CONSIDER WHEN DEDUCTING SALARIES FOR COVERED EMPLOYEES?

This is an issue faced mostly by later stage emerging companies that have gone public. When deducting salaries paid to "covered employees," defined as the CEO and the other four highest paid employees during a taxable period, you must comply with Section 162(m) of the IRC. Under Section 162(m), compensation exceeding $1 million paid to a covered employee of a public company is not tax deductible. Companies can follow three easy steps to ensure that the compensation is exempt from 162(m). First, the compensation must be tied to certain performance goals determined by a compensation committee. Second, the terms must be disclosed to shareholders and approved by a majority; and (iii) the compensation must bee approved by the compensation committee. Once these three requirements are met, the compensation would be exempt from Section 162(m) and may be deducted.

CONCLUSION

Ultimately many of the issues surrounding equity compensation are complex and require the advice of a seasoned legal advisor or tax professional. When structuring equity or performance compensation the goal of rewarding employees and service providers must be balanced with the regulatory requirements for compliance. It is prudent at the early phase when considering such a compensation structure to seek legal advice to ensure that both the company and the employees or service providers receive the desired benefit of the compensation structure.