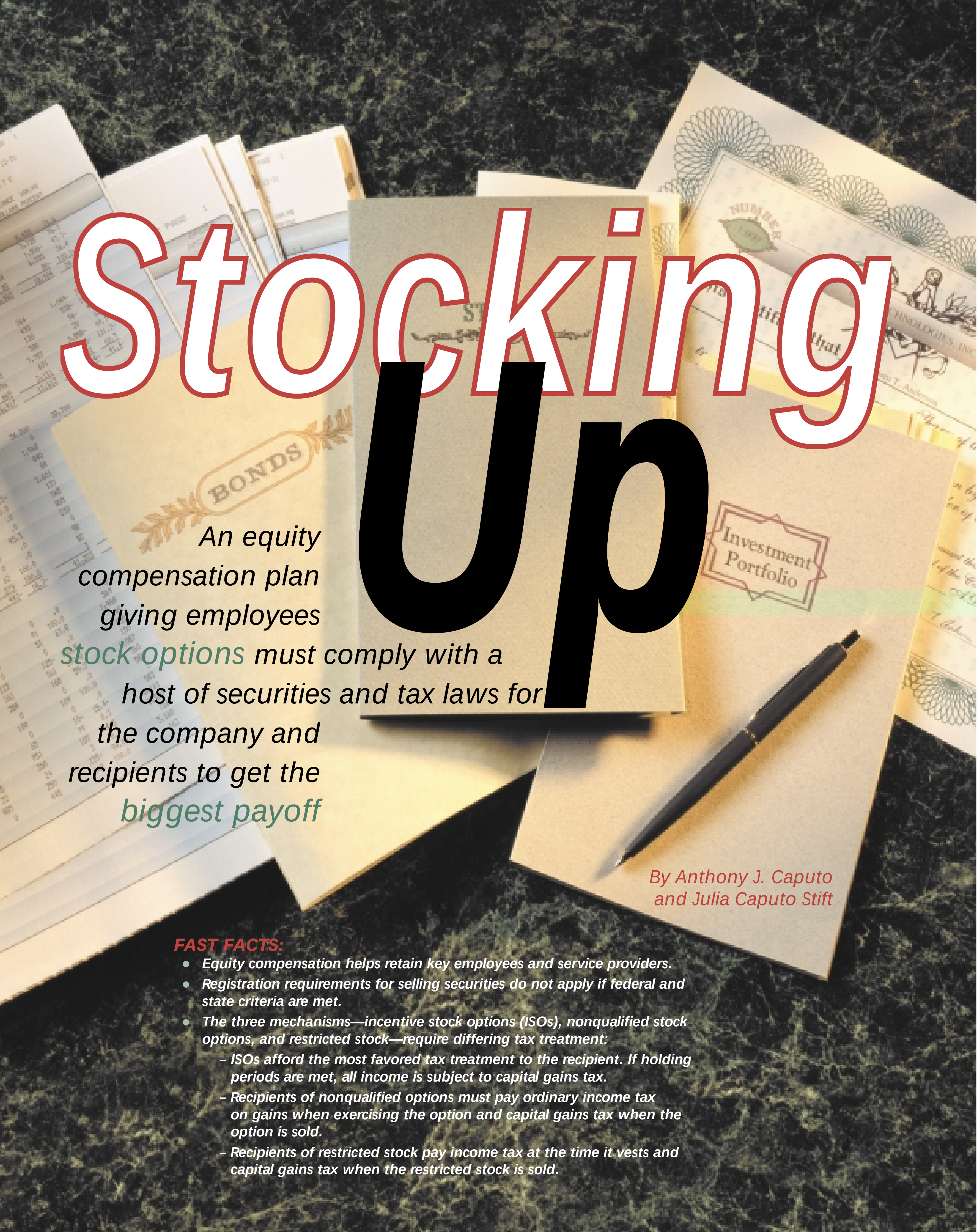

Stocking Up

An equity compensation plan giving employees stock options must comply with a host of securities and tax laws for the company and recipients to get the biggest payoff

By Anthony J. Caputo and Julia Caputo Stift

FAST FACTS:

- ***Equity compensation helps retain key employees and service providers.***
- ***Registration requirements for selling securities do not apply if federal and state criteria are met.***
- ***The three mechanisms—incentive stock options (ISOs), nonqualified stock options, and restricted stock—require differing tax treatment:***
  - ***ISOs afford the most favored tax treatment to the recipient. If holding periods are met, all income is subject to capital gains tax.***
  - ***Recipients of nonqualified options must pay ordinary income tax on gains when exercising the option and capital gains tax when the option is sold.***
  - ***Recipients of restricted stock pay income tax at the time it vests and capital gains tax when the restricted stock is sold.***

In this time of rapid economic growth and ever riskier business ventures with their potential for exponential rewards, companies are discovering that often the only way to retain the employees, directors, and consultants necessary to successful company business ventures is to give such service providers an opportunity to share in the ultimate profitability of the enterprise. The efforts of companies to recruit and retain quality people has led to an explosion of equity compensation mechanisms designed to meet the special concerns of these service providers and their employees.

When an employer considers an equity compensation program it must carefully evaluate the dilutive effect on current shareholders. The company also will want to make sure that the equity compensation vehicle actually aligns the interests of service providers with those of the company. Employers need flexible equity incentive vehicles that permit compensation packages to be tailored specifically for key employees. Employees expect that high performance will give rise to maximum reward.

To address these issues, many companies have implemented stock incentive plans that grant several different forms of equity compensation to the service providers. The three most common forms of equity compensation are incentive stock options, nonqualified stock options, and restricted stock.

Incentive Stock Options

Incentive stock options (also referred to as statutory stock options or ISOs) must meet all of the requirements set forth in Internal Revenue Code (IRC) Section 422. Employees generally prefer ISOs to nonqualified stock options because ISOs are advantageous to the recipient. This special tax treatment will not be realized, however, if an ISO does not comply with all of the many statutory requirements. Specifically, an ISO

- Must be granted to an individual as part of an equity compensation plan, and the option must be offered in connection with the individual's employment by the issuer
- Must be granted under a plan that states the aggregate number of shares for which options may be issued, states the employees eligible to receive options under the plan, and is approved by the company's shareholders within 12 months before or after the plan's adoption
- Must be granted within 10 years from the date the plan was adopted or approved by the shareholders, whichever is earlier
- Must not be exercisable after 10 years from its date of grant
- Must not have an exercise price that is less than the fair market value of the underlying stock at the time the option was granted
- Must be nontransferable other than by will or the laws of descent and distribution
- Must be exercisable, during the optionee's lifetime, only by the optionee (However, at the time the option is granted, if the recipient of an option owns more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or of a parent or subsidiary of the employer corporation, the option will not qualify as an ISO. Provided the exercise price is at least 110 percent of the fair market value of the stock at the time the option is granted, the option is not exercisable after five years from its date of grant.)
- May not present itself as other than an ISO (Any option that specifically states that it will not be treated as an ISO is not an ISO, regardless of its terms.)
- May not result in an individual's receiving ISOs from any issuer with an aggregate fair market value of more than $100,000 (as determined on the date the ISOs were granted) becoming exercisable for the first time in any given calendar year. (If the maximum value of options first exercisable by an individual in a calendar year exceeds $100,000, the excess will not be treated as an ISO.)

For example, if an employee is granted options intended to qualify as ISOs for stock that has an aggregate fair market value of $500,000 at the time of grant and the options vest 20 percent per year over a five-year period, the entire amount of the options can constitute ISOs because the amount of stock for which options become exercisable in any given year is $100,000.

Future increases in the fair market value of the stock will not affect the determination of whether or not the options qualify as ISOs since the fair market value of the stock for purposes of the $100,000 limitation is determined at the time the options are granted. If, however, the employee receives an additional grant of stock options with a fair market value at the time of grant of $10,000 and these additional options vest in the third year of the initial ISO grant, the additional $10,000 of stock options cannot constitute ISOs because, in the year they vest, the amount of ISOs received cannot exceed $100,000. The excess will be treated as nonqualified stock options.

Nonqualified Stock Options

Nonqualified stock options are stock options issued as equity compensation that fail to meet the requirements of an ISO. Most significantly, nonqualified stock options may be granted to all service providers rather than just to employees. Nonqualified stock options must meet the requirements of federal and Michigan securities laws to obtain an exemption from the registration of transactions involving a sale of securities.

Restricted Stock

Restricted stock is a means by which company management can seek a closer alignment of the interests of service providers with the interests of the company by immediately granting service providers a direct equity interest in the company. A company often wants to use the stock issued to retain the recipient employee or other service provider. When using stock as a retention tool, the stock a company issues to its service providers is either forfeited or may be bought by the company according to a predetermined price or formula if the person terminates the relationship with the company before the restrictions lapse on the granted stock.

Tax Consequences

The tax treatment imposed on an equity compensation vehicle differs markedly from plan to plan. At the time of issuance, none of these equity compensation vehicles have any federal income tax consequences for service providers or employers. However, the overall tax consequences of ISOs, nonqualified stock options, and restricted stock differ substantially. (See table on next page, "Tax Treatment of Equity Compensation Vehicles.")

Tax Treatment of Equity Compensation Vehicles

The following figures demonstrate the different tax consequences for recipients and issuers of incentive stock options, nonqualified stock options, restricted stock, and restricted stock subject to an election under Section 83(b) of the Internal Revenue Code

	Incentive Stock Options ($)	Nonqualified Stock Options ($)	Restricted Stock ($)	Restricted Stock Subject to a §83(b) ($)
Fair Market Value (FMV) of Underlying Stock at Time of Grant	1	1	1	1
Purchase Price Paid	1	1	1	1
FMV of Underlying Stock at Time of Vesting	5	5	5	5
FMV of Underlying Stock at Time of Exercise	5	5	NA	NA
FMV of Underlying Stock at Time of Disposition	10	10	10	10
At Time of Grant	None	None	None	Recognition of $0 ordinary income (FMV at time of grant minus purchase price); corresponding business expense deduction to employer
At Time of Vesting	None	None	Recognition of $4 ordinary income (FMV at time of vesting minus purchase price); corresponding business expense deduction to employer	None
At Time of Exercise	None	Recognition of $4 ordinary income (FMV at time of exercise minus exercise price); corresponding business expense deduction to employer	NA	NA
At Time of Disposition	Recognition of $9 of capital gain (FMV at time of disposition minus exercise price)	Recognition of $5 of capital gain (FMV at time of disposition minus FMV at time of exercise)	Recognition of $5 of capital gain (FMV at time of disposition minus FMV at time of vesting)	Recognition of $9 of capital gain (FMV at time of disposition minus FMV at time of grant)
Summary	Gain of $9 recognized; taxed entirely at lower capital gain rates	Gain of $9 recognized; taxed partially at ordinary income rates and partially at capital gain rates	Gain of $9 recognized; taxed partially at ordinary income rate and partially at capital gain rates	Gain of $9 recognized taxed entirely at lower capital gain rates

Equity compensation has long been a method of placing "golden handcuffs" on key personnel by tying their financial interests to the success of the employing company.

ISOs are designed to provide tax advantages to employees. At the time the options vest, the employee does not incur any federal income tax consequences. Similarly, at the time the employee chooses to exercise an ISO, no ordinary income or capital gain is recognized. The issuing corporation, however, does not receive any business expense deduction in connection with the exercise of the option. The difference between the fair market value of the stock at the time of disposition and the exercise price is taxed at the long-term capital gain rates that are in effect when the stock is disposed of, so long as (a) the disposition occurred more than one year after the acquisition of the stock and more than two years from the date of grant of the option, and (b) the optionee was an employee of the issuing corporation, or a parent or subsidiary of the issuing corporation, throughout the period beginning on the date the option was granted and ending on a date three months before the date the option was exercised.

If the optionee has not held the stock for at least two years from the date the option was granted and at least one year from the date the option was exercised, the option fails to be an ISO and is treated as a nonqualified stock option. In that event, the optionee is taxed at ordinary income tax rates upon the lesser of 1) the difference between the fair market value of the stock at the time of disposition and the exercise price, and 2) the difference between the fair market value of the stock at the time the option was exercised and the exercise price. If the fair market value of the stock at the time of disposition exceeds the fair market value of the stock at the time of exercise, the optionee is taxed on the difference at capital gain rates.

As with ISOs, there are no federal income tax consequences for service providers or employers at the time that nonqualified stock options are granted or at the time they vest; however, upon the exercise of a nonqualified stock option, the service provider is taxed at ordinary income tax rates on an amount equal to the difference between the fair market value of the stock at the time of exercise and the exercise price. The company receives a business expense deduction equal to the amount of ordinary income recognized by the service provider.

Regardless of the long-term effects of the surge in equity compensation on the market, it is clear that equity compensation is currently preferred over enormous salaries as a way to secure and retain talent in the technology arena.

Upon the disposition of the acquired stock, the service provider recognizes long-term capital gain equal to the difference between the fair market value of the stock at the time of disposition and the fair market value of the stock at the time the option was exercised, provided that the service provider has held the stock for at least one year. Service providers who have held the stock for less than one year at the time of disposition will be taxed at short-term capital gain rates.

In contrast to ISOs, which result in pure capital gain to a service provider, a portion of a service provider's gain from nonqualified stock options is taxed at the higher, ordinary income tax rates. The employer has a potential tax advantage from nonqualified stock options as a result of the business expense deduction it receives for the portion of the gain deemed to constitute compensation to a service provider that is taxed at ordinary income tax rates.

As compared to options, which for tax purposes are generally not deemed to be property, the taxation of restricted stock is controlled by IRC Section 83, which pertains to property transferred in connection with the performance of services. Property received in connection with the performance of services generally is not subject to taxation until it ceases to be subject to a substantial risk of forfeiture. A person's rights to property are subject to a substantial risk of forfeiture if the rights are conditioned upon the future performance of substantial services. Thus, the issuance of restricted stock does not result in any immediate federal income tax consequences.

Upon vesting of the restricted stock and the concurrent lapse of the substantial risk of forfeiture, the holder of the restricted stock is subject to ordinary income tax on the difference between the fair market value of the stock at the time of lapse and the amount paid, if any, for the restricted stock. The employer receives a business expense deduction equivalent to the amount of ordinary income recognized by the holder of the restricted stock. Upon disposition of the restricted stock, the holder recognizes long-term capital gain equal to the difference between the fair market value at the time of disposition and the fair market value at the time the restriction lapsed, provided that the holder of the restricted stock has held it for more than one year from the date of grant. Service providers who dispose of restricted stock that has been held for less than one year will be taxed at the short-term capital gain rate.

Under certain circumstances, a recipient of restricted stock may prefer to be taxed at the time of its receipt rather than at the time the substantial risk of forfeiture lapses. For example, if a service provider is granted restricted stock at a time when the stock of the employer has an extremely low fair market value and the service provider expects the stock to appreciate substantially before the restriction lapses, the service provider may prefer to recognize the difference between the current fair market value and the price paid for the stock, if any, as ordinary income at the time of grant rather than recognize the difference between the presumably higher fair market value at the time the restriction lapses and the price paid for the stock, if any. The service provider is permitted to choose this immediate recognition of income pursuant to a Section 83(b) election.

If a recipient makes a Section 83(b) election, the excess of the fair market value at the time of transfer over the price paid, if any, for the property is included in the recipient's income at the time of transfer. A Section 83(b) election is made by filing a written statement with the office of the Internal Revenue Service to which the service provider files his or her return. The written statement must comply with the requirements of IRC Section 83(b). A copy of the written notice must be attached to the service provider's tax return for the year in question. In addition, the person who performs the services must submit a copy of the written statement to the employer. The election must be made within 30 days of the service provider's receipt of the restricted stock and is irrevocable. Thus, if a service provider makes a Section 83(b) election and subsequently forfeits the restricted stock, the service provider is precluded from backing out of the transaction or taking a deduction or loss in the amount of the gain previously recognized as a result of the election.

At the time a service provider disposes of property for which a Section 83(b) election was made, the transferee recognizes long-term capital gain equal to the difference between the fair market value of the stock at the time of disposition and the fair market value of the stock at the time of grant as long as the service provider has held the stock for at least one year. A service provider who has made a Section 83(b) election and disposes of restricted stock held for less than one year will be taxed at short-term capital gain rates.

Conclusion

Equity compensation is not merely a product of the recent boom in technology stocks. It has long been a method of placing "golden handcuffs" on key personnel by tying their financial interests to the success of the employing company. The recent dot-com and technology stock craze has popularized the mass use of stock options and restricted stock as mechanisms to lure talented individuals toward risky business ventures and then to induce them to stay.

Some business commentators criticize the widespread use of incentive stock awards and equate the lure of stock options to the Gold Rush of 1849. These commentators hypothesize that while everyone is rushing to strike it rich by joining a company that will grant them stock options, only those companies with solid business plans underlying their stock options will actually turn out to be "gold mines" for these speculators. These same commentators are concerned that weak business ventures are drawing needed employees away from traditional service industries with the promise of vast financial rewards that may not materialize. The rational concern is that individuals drawn by such expected wealth will be severely disappointed employees if these expectations are not met. Such people will not be loyal to their employers.

In light of the instability of technology stocks in recent months, it appears that many of these predictions have come to pass. Professional recruiters are reporting vastly increased demand for their services as service providers decide to forgo worthless stock options for a new opportunity. Regardless of the long-term effects of the surge in equity compensation on the market, it is clear that equity compensation is currently preferred over enormous salaries as a way to secure and retain talent in the technology arena. ✦

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