Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 33:
The ABCs of Stock Options and Other Equity Awards: Which One Works Best for You?

By Darren Goodman, Sophia Mokotoff, Taryn Cannataro

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Taryn Cannataro: Welcome to the latest episode of Just Compensation. I'm Taryn Cannataro, counsel in Lowenstein's Employee Benefits & Executive Compensation Group. I'll turn it over to my colleagues to introduce themselves.

Darren Goodman: I'm Darren Goodman. I'm the Vice Chair of Lowenstein Executive Compensation & Employee Benefits Group.

Sophia Mokotoff: Hi, I am Sophia Mokotoff, a partner in the Tax group here at Lowenstein.

Taryn Cannataro: Today's discussion will focus on the various types of equity awards that can be issued by a corporation.

Most people are familiar with stock options, but there are also a number of different equity awards that can be issued by a corporation, each have their own benefits and drawbacks.

Today, we will go over the various types of awards, the typical tax treatment, and some of the pros and cons of each type of award. As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you wish to grant new equity awards. Darren, can you tell us what are the various types of equity that can be issued by a corporation and how the awards are usually made?

Darren Goodman: Equity awards from a company are typically issued under an omnibus equity incentive plan and documented by individual award agreements, which are usually on the same floor.

Common types of awards that can be issued under the plan are stock options, restricted stock, restricted stock units, and we'll talk about the differences between restricted stock and restricted stock units. And also, other types of awards such as stock appreciation rights, although other types of awards are less common than option restricted stock or restricted stock units.

Taryn Cannataro: Let's discuss each of these equity awards. What are they? How are they taxed and why would a company choose to issue them? Do you want to start with stock option?

Darren Goodman: Sure. So stock options, people are generally familiar with them. An option gives someone a right to buy stock at some point in the future, exactly when will be determined based on the terms of the option.

There are two different types of stock options: incentive stock options commonly called ISOs and non-qualified stock options commonly called NSOs. The difference between ISOs and NSOs is purely tax driven. So whether someone gets an ISO or an NSO, they are not taxed when the option is granted. They are also not taxed when the option vests.

There is a tax event when the option is exercised, whether ISO or NSO. So if someone has an NSO, any gain at the time of exercise is ordinary income. So if the exercise price is $5 and the stock is worth 15 at the time of exercise, there's $10 of ordinary income.

If someone has an ISO, that gain is not ordinary income at the time of exercise. But something that can be a trap for people who aren't aware and hold a lot of ISOs is that the gain does count for purposes of determining whether someone is subject to the alternative minimum tax, which is in general a tax that's aimed at high income taxpayers.

So what can sometimes happen is people think that they don't have any tax and exercise of ISOs, then they go to do their taxes the next year and they find out that they're hit with a bill they're not expecting under the alternative minimum tax.

Because ISOs are eligible for potential tax benefits, there are also a number of rules that they must satisfy under the Internal Revenue Code. A couple of big ones are, first, the exercise probably has to be at least a 100% of fair market value, which is not normally a big deal because Section 409A of the code normally separately requires that.

But if someone's a 10% stockholder, such as a founder getting an ISO grant, their ISO must have an exercise price of 110% of fair market value on the date of grant. A lot of people aren't aware of that, and if you don't meet that requirement, if you grant a 10% holder in ISO, it's not going to be an ISO because the exercise price is too low.

Another requirement that impacts 10% stockholders is that the term of the ISO can be no more than it's five years. So options are almost always granted with a specific expiration date. The norm is 10 years, but for 10% stockholders it has to be five.

Other key terms of options include the vesting schedule, it can be time-based or performance-based or both. For something that's time-based, it's typical to have a four-year schedule with at least a one-year cliff vesting date.

Common example would be an option grant vests one quarter one year after the date of grant and then monthly thereafter over three years for a total of four years. And then typically once vested the option holder can exercise any number of shares at any time that they like as long as they pay the exercise price and satisfy any tax withholding.

Taryn Cannataro: So there are pros and cons with issuing options to service providers. A few of the benefits of stock options are that there's no tax until the option is exercised or until sale of a shares if the options are ISOs. That would be different if the options are non-qualified stock options.

Employees can also hold the options for a long period, typically 10 years before they're required to exercise or forfeit the shares and once, they exercise, employees have the opportunity to own shares in the company.

One of the drawbacks is that employees have to pay exercise price to obtain the shares when the option is exercised. Also, because the exercise price is usually at least a 100% of the fair market value as a time of grant, the options don't have any value unless the fair market value increases after the options are granted.

Like Darren said earlier, ISOs are also subject to complex tax rules and as a result individuals don't often receive the tax benefits. For example, ISOs can only be granted to employees and do not get favorable tax benefits if there's a disqualifying disposition.

In general, a disqualifying disposition occurs when the shares acquired upon exercise of ISOs are not held until at least two years from the date of grant and more than one year from the date of exercise. If this happens, the option you must recognize ordinary income in the year of disqualifying disposition in an amount equal to the lesser of fair market value on the date of exercise minus the exercise price or the amount realized on the disposition minus the exercise price.

The remainder of any gain will be treated as short-term or long-term capital gain depending on whether the stock has been held for more than a year. Also, for ISOs, the excess of the fair market value of the stock on the date of exercise over the exercise price will be taken into account when determining whether the alternative minimum tax will apply for the year of exercise as Darren stated earlier. Additionally, there's no immediate stock ownership until the option exercises and stock option.

Darren Goodman: I wanted to go back to one point you mentioned, Taryn, which is the 10-year term of the options. For some companies that are private, they expect to sell or go public within 10 years, but then for whatever reason they don’t, and they approach the point where stock options are approaching their expiration date. And it's impractical for people to exercise because either the exercise price or the tax bill or both would be too high, and they want to extend that 10 year date.

It gets pretty technical, but long story short, that may not be possible and actually often isn't possible without causing tax penalties to be triggered under Section 409A. So it's something that people should be aware of and just start planning for well in advance of approaching the 10-year expiration date for their options.

One other point to cover is that options can be structured as what are called early exercise options. Under an early exercise option, the option has a traditional vesting schedule, but the employee is eligible to exercise those options from day one even though the options aren't vested.

If they do exercise those options before they're vested, they would receive stock that would vest on the same schedule that would've applied to the stock options. So the stock would be restricted stock for tax purposes and that pivots to the next main type of awards under an equity plan, restricted stock awards.

Taryn Cannataro: Restricted stock is the grant of actual shares of stock that's subject to forfeiture if time-based and or performance-based conditions are not met. Typically, these shares are contingent on continued employment through the date of vesting.

Employees are taxed an ordinary income based on the fair market value of the restricted shares at the time the shares are no longer subject to forfeiture. Many people choose to file an 83(b) election, which can be made to accelerate the tax to the time of grant based on the fair market value at the time of grant.

A few things to note with respect to 83(b) elections are that they must be made within 30 days of the date the restricted shares are granted. Also, you do not get the tax back if the shares are later forfeited after you pay the tax at the time you file the 83(b) election.

Darren Goodman: Taryn, just to add to that, the 30-day deadline is critical because on day 31, it's too late. There are no extensions and there's no silver bullet for fixing it if an employee wanted to make an 83(b) election and miss the deadline.

So it's very, very important to make that election. And what often happens in practice is that companies, particularly early-stage companies where their stock has minimal value, grant restricted stock awards, the employee makes an 83(b) election and they have very little includable and income because the stock has very little value. So it can provide a real potential tax savings.

Taryn Cannataro: There is also the potential for long-term capital gain on any increase in value on the restricted stock after the stock is initially taxed, and withholding is required at the time the employee has any income tax due. The company also receives a tax deduction equal to the employee's ordinary income.

There are benefits and drawbacks to issuing restricted stock. A few benefits are that unlike stock options, there's no exercise price or purchase price required, and it promotes immediate stock ownership. Also, restricted stock may be less dilutive than options because fewer restricted shares are typically granted than option because restricted stock are full value award. So participants have the ability to share from dollar one rather than having to exercise to obtain the shares.

One of the drawbacks is that shares will be taxed when they're vested if no 83(b) election is made, or if an 83(b) election is made, the employee may have paid tax on stock that's forfeited later or that doesn't monetize.

Darren Goodman: Just to illustrate Taryn, so in my example where someone gets stock in an early-stage company and they file an 83(b) election, they could lock in a low ordinary income tax bill in the 83(b) election, start the long-term capital gain clock, and then assuming the company's value goes up, have a very nice tax savings there.

But if they miss the election and they're taxed as in when the shares vest, if the company is well, they'll have a larger and larger tax bill as the shares vest. So it just reemphasizes the importance of filing the 83(b) election timely in that scenario.

Just to turn to the next main type of equity awards, restricted stock units, the difference between restricted stock and restricted stock units is that if someone gets a restricted stock award, they're receiving stock on the date that the award is approved. They're an actual stockholder. They normally have stockholder rights.

If someone's granted a restricted stock unit, they're granted a right to shares in the future, but they're not actually issued any shares on day one. They're only issued the shares usually at or after shortly after the time the RSU is vested.

So the RSUs can have a time or performance vesting schedule or both just like stock options or restricted stock. When the employee is issued shares, they're fully vested, and the employee will have an income tax bill based on the fair market value of the shares at the time the shares are issued.

Now, a couple of benefits of RSUs. First, like restricted stock, no exercise or purchase price, and their full value award so people share in the full value of the shares. They can be particularly appealing for a company that's a late-stage startup where the stock has significant value.

So an 83(b) election to be taxed on a grant would be unappealing, where a stock option with an exercise price of fair market value would also be unappealing because people will miss out on that existing value and it might be cost prohibitive to exercise. So those are examples where RSUs can make a lot of sense and you can also delay the tax bill until the shares are issued.

The biggest downsides for RSUs is for private companies where if you issue stock and someone is taxed on the full value while a company's private, they have a tax bill but they don't have the liquidity and the shares to pay it.

So what we see, and we cover it in more detail at a separate podcast episode, is issuance of double vesting RSUs, where long story short, there's a time vesting element, normal schedule such as four years, but there's also a requirement that the company have a sale or IPO before a deadline that's driven by tax reasons.

And as long as you have the time vesting and the sale or IPO before the deadline, the shares will then be issued. And by deferring the issuance of the shares until the company is sold or has gone public, the idea is that people get the shares and have the tax bill at the time there is liquidity in the stock, and they can afford to pay the taxes. So Taryn, do you want to cover SARs?

Taryn Cannataro: Sure. A SAR gives an award holder the right to receive the appreciation and value of a specific number subject to forfeiture based on time or performance-based requirements. Again, this is typically contingent on continued employment. Similar to RSUs, SARs can be settled in stock or cash or a combination of both, but in practice most SARs are typically paid out in cash.

The exercise price must be at least fair market value and upon exercise, a SAR holder is entitled to amount equal to or shares equal to the excess of the fair market value of the underlying shares on the date of exercise over the exercise price, which is often referred to as the spread.

SARs are less commonly issued than options, restricted stock awards, and RSUs. Similar to option, the employee is taxed at ordinary income rates based on the spread or the appreciation when the SARs are paid out or the shares are issued, and the company receives a tax deduction equal to the employee's ordinary income.

Some benefits of SARs are that they allow SAR holders to share in the company's growth without diluting the shareholders by issuing actual shares. Also, SAR holders can control the tax timing by deciding when they want to exercise their SARs and they don't have to worry about whether there's liquidity because SARS can be settled in cash.

A few drawbacks are that they must be structured to comply with the complex rules of Section 409A, which has been the subject of some of our previous podcast episodes. Like option, they can also become underwater if the value of the stock drops compared to the exercise price. And if they're settled in cash, it could require the company to come out of pocket and pay cash upon exercise.

So now that we've talked about the different types of awards that can be issued, if a company wants to issue equity awards, Sophia, does it matter if it's a C corporation or an S corporation?

Sophia Mokotoff: Yeah, definitely. The discussion so far has assumed that the company issuing these equity awards is a C corporation for tax purposes. Certain corporations may have elected to be S corporations for tax purposes.

The difference between a C corp, but an S corp may not be apparent from the legal entity name. So you may need to find out more to confirm whether a company is a C corporation or an S corporation.

S corporations are pass throughs for income tax purposes, so generally there's no company level income tax imposed. Instead, the income and losses earned by the company passes through to the shareholders or tax at the shareholder level. The reason why this is important in this context is the Internal Revenue Code imposes several restrictions on S corporations. If an S corporation fails to satisfy one of these requirements, the entity could lose its S corporation status and be treated as a C corporation.

A common issue that comes up with respect to S Corporation stock awards is whether the awarded shares constitute an impermissible second class of stock. Under the S corp rules, if the S corporation at any time has more than one class of stock, it loses its S corp status. Note that even phantom arrangements could be deemed a separate class of stock for purposes of these S corporation rules.

Another issue we see come up relates to permissible S corporation shareholders. Are the shares being awarded to an impermissible shareholder? Only individuals in certain types of entities are eligible to be S Corporation shareholders. This includes US citizens and residents, estate of deceased S Corporation shareholders, the estate of bankrupt S corporation shareholders, certain types of trusts, and certain tax-exempt organizations.

So ineligible shareholders are: corporations, entities treated as partnerships for tax purposes, and non-resident alien individuals. So an example of where we might see an issue come up is where a company issues stock to, for example, a non-US individual. This could blow the company's S corp status.

Another issue we see relates to the requirement that S corporations are only permitted to have a hundred shareholders. So clearly this would limit the number of employees who could receive equity in an S corporation.

Darren Goodman: And Sophia, just to kind of recap, if a company is an S corporation and wants to adopt an equity incentive plan, it can be done, but it's really important to be mindful of these restrictions and to work with counsel really every time you grant awards to make sure you're not doing anything that could cause the company to lose its S corp status because the consequences of that could be pretty catastrophic.

Taryn Cannataro: Any other considerations to be aware of?

Darren Goodman: And we've been pretty focused on the tax law aspects, but securities law also needs to be considered by companies. For public companies, there's a form essay that can be filed to register the shares that will be issued under the equity plan. It's a streamlined form much simpler than an S one, for example.

For private companies, grants are usually made in reliance on Rule 701 at the federal level. It's an exemption for awards issued to employees or some consultants under equity plans.

The key thing to know about 701 is that there are limits on how much can be issued in each 12 month period, and there is also a separate $10 million limit on the amount that can be issued during a 12-month period without triggering additional financial disclosure requirements.

So for a company that is private and using CardUp, CardUp track this for them. It's important to be mindful of this, particularly in advance of any large scale grants, and if a company thinks that it is bumping up against or may have already exceeded any 7 0 1 limit, it's important to work again with counsel because it's possible that grants could fit in other exemptions or it's possible that other things could be done to bring the company either back within the limit or avoid going over the limit in the first place.

Taryn Cannataro: As you've heard today, there are a number of different types of equity awards that a corporation can issue. Deciding on what type of award is right for your company often depends on the life stage of your company and the company's plan for the future.

We suggest you reach out to your benefits' council if you're looking to make equity awards under a new plan or expand the type of awards issued under an existing plan to decide what type of awards are right for your company.

This episode is intended to be a high level overview but is by no means an exhausted discussion. Thank you for joining us today. We look forward to having you back for our next episode of Just Compensation.

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