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PROFESSIONAL RESPONSIBILITY

Questions about tax rules for pricing options

By Michael Shaff

1. Are there special tax rules on setting the exercise price of options issued to employees and consultants?

There are special rules for incentive stock options that a corporation can issue to an employee. Among those rules, the exercise price of the incentive stock option cannot be less than the stock price on the date that the option is granted. Internal Revenue Code Section 422(b) (4). Incentive stock options give rise to income for the option holder when the stock purchased on the exercise of the option is sold. IRC Section 421(a).

Nonqualified options that can be issued by a corporation or a limited liability company in general also must have an exercise price no less than the value of the issuing entity's stock as of the date of issuance. Treas. Reg. Section 1.409A-1(b)(5) (i)(A). If an option that is generally exercisable by the recipient is issued with an exercise price less than the value of the stock as of the date of grant, the option recipient faces an income inclusion in the amount that the value of the stock exceeds the exercise price and annual income inclusions in the amount that the value of the stock increases over the previous inclusion. IRC Section 409A(a) (1)(A)(i). In addition, the option recipient faces an annual penalty of 20 percent of the compensation required to be included that year under Section 409A as well as a higher penalty interest rate. IRC Sections 409A(a)(1)(B)(i) (II) and 409A(a)(1) (B)(ii). The income inclusion, penalty and higher interest adversely affect



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the key employee or consultant who received the in-the-money option.

2. What if an employer really wants to issue an in-the-money option to a key service provider?

There are a couple of ways that an employer can issue an option with an exercise price less than the value of the employer's stock on the date of issue without creating adverse income tax consequences for the option recipient. Section 409A exempts from its application any short-term deferral of compensation, meaning compensation that is deferred for no more than 2 ½ months after the end of the year that the option or other deferred compensation is granted. Treas. Reg. Section 1.409A-1(b) (4). The applicable year can be either the employee's tax year (typically the calendar year) or the employer's tax year. Treas. Reg. Section 1.409A-1(b)(4)(i) (A). Under that exception, if the option had to be exercised no later than the following March 15 (or 2 ½ months after the end of the employer's tax year if later), it could be issued with an exercise price in the money.

Another way to issue an in-the-money option without running afoul of Section 409A would be to limit the option's exercisability to one or more of six specified events: (i) separation from service, (ii) the date the participant becomes disabled, (iii) death, (iv) a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation, (v) a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation, or (vi) the occurrence of an unforeseeable emergency. IRC Section 409A(a)(2) (A).

In the context of a privately held employer, the option holders may prefer to defer the exercise of their options until the occurrence of one of the specified events, especially if the specified time for exercise of the option is the completion of the initial public offering of the employer's stock. By limiting exercisability of options granted to a change in control of the employer or the completion of a qualifying public offering of the employer's stock pursuant an effective registration statement, the employer may be able to offer in-the-money options to key employees.

The applicable regulation imposes restrictions on the duration that the in-the-money option may be exercisable after the specified event. Treas. Reg. Section 1.409A-3(i)(1) (i). The in-the-money option must be exercised no later than a date within the same tax year of the service provider, or (b) the 15th day of the third calendar month following the specified date. Treas.

Reg. Section 1.409A-3(d). The payment with respect to a stock right generally occurs upon the exercise of the stock right, so that where a stock right designates a fixed exercise date, the stock right will be deemed to have been paid at such date if the exercise and payment occur on such date or a later date within the same taxable year of the service provider.

3. What are other "stock rights" that might be issued to key employees?

Other "stock rights" that an employer (a service recipient in the language of the Section 409A regulations) might issue include incentive stock options, phantom stock, stock appreciation rights and restricted stock grants.

Incentive stock options are most valuable when the issuer is a publicly traded corporation. By not generating income on grant or exercise incentive stock options afford the opportunity for the employee to obtain capital gain treatment on the sale of the stock. Incentive stock options are available only for a recipient who was an employee at the time of grant and at the time of exercise or who ceased to be an employee no more than three months before the exercise of the option. IRC Section 422(a) (2). The exercise of an incentive stock option gives rise to alternative minimum taxable income. IRC Section 56(b)(3). In the case of a private company, the typical option holder defers exercise of the option until a liquidity event, making the opportunity to obtain long term capital gain treatment less important as in the case

where the employee's holding period may only be the moments between exercise of the option and the closing of the liquidity event.

Phantom stock is the obligation of the employer to pay the service provider with a cash bonus equal to the value of a share of the employer's stock on the occurrence of an agreed event. Preferred stock is "nonqualified deferred compensation" under the rules of Section 409A and therefore may only be paid on the occurrence of one of the six acceptable events discussed in the answer to question two above.

Stock appreciation rights represent the employer's obligation to pay the service provider a cash bonus equal to the difference between the value of the employer's stock on the date of grant (or some other higher base value) and the value on the date that the right is exercised. Treas. Reg. Section 1.409A-1(b)(5) (i) (B). A stock appreciation right that conforms to the definition in the previous sentence may be exercised at any time permitted in the grant agreement — mean-

ing that its exercise is not limited to the six events discussed in the answer to question two above.

Restricted stock is taxed under a completely different regime. IRC Section 83. The general rule is that the value of restricted stock is taxed as ordinary income when the restriction lapses. IRC Section 83(a)(1). In appropriate cases — where the employee believes that the value of the employer's stock is likely to greatly increase by the time the restriction lapses — the recipient may elect to include the value of the restricted stock in income on receipt of the restricted stock despite the risk that the employee may have to forfeit the stock on the occurrence of events specified in the grant agreement. The election, popularly known as an 83b election, must be made within 30 days of the grant of the restricted stock or other property. IRC Section 83(b).

4. Is there any kind of stock based equity incentive that is not subject to all those rules?

Restricted stock units represent an arrangement under which an employee has the right

to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. The employee's right may be subject to a condition, such as continued employment for a certain period or the attainment of performance goals. General Explanation of Public Law 115-97 (TCJA of 2017 Blue Book) at 270. The general rule for RSUs is that no taxable event occurs on issuance or exercise, only on the issuance of stock, cash or other property to the recipient of the RSU.

A "qualified employee" who receives stock from an "eligible employer" on the exercise of a stock option or in settlement of an RSU may elect to defer income from the receipt of the stock for up to five years. IRC Section 83(i)(1). For purposes of the election, "qualified stock" is stock as to which the employee does not have the right to sell back to the issuing corporation. IRC Section 83(i)(2)(B). A "qualified employee" is an employee other than a 1 percent or more shareholder, a current or former CEO or CFO or one of

their family members or other affiliates. IRC Section 83(i)(3) (B). Unfortunately, the definition of "qualified employer" may exclude a significant percentage of companies issuing RSUs as a qualified employer must be both a company whose shares are not publicly traded and which has adopted a plan pursuant to which at least 80 percent of the company's employees have been issued options or RSUs. IRC Section 83(i) (2)(C)(i).

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