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Taking Stock: An Introduction to Equity-based Compensation

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This article provides a basic introduction to the different types of equity-based compensation that may be provided by employers. It is important to keep in mind that many types of equity-based compensation reach beyond the executive suite to a much broader group of employees. Compensating employees with equity is intended to create a sense of common ownership between employees and shareholders and directly align individual employee performance with specific company goals.

Granting equity in the company may reinforce a mutual commitment to achieving the long-term goals of the employer. While the fundamental concept may seem simple, different equity compensation structures may be required for different types of employees. For example, different motivators and performance criteria often are appropriate for senior executives and critical leadership versus technical or sales talent.

A key to designing a successful equity-based compensation program is understanding the underlying goal of the company. For example, is the company most concerned with improving short-term operational results or long-term strategic value creation? Is the proposed equity compensation meant to attract new talent, retain existing employees or motivate employees to “get on board” in meeting a specific target? Once the specific goals of the program have been determined, employers may choose from a variety of equity-based compensation alternatives discussed next.

A thorough discussion of design considerations is outside the scope of this article, but it is an important first step in determining which form



of equity compensation will fit a company's needs. This article is intended to be an introduction to different types of equity-based compensation and highlights some of their key features and tax treatment. A complex set of legal, accounting and tax issues, including specific income tax withholding rules, are involved with equity-based compensation, and thoughtful planning is critical. This article will touch on key aspects of the legal and tax framework

but will not address accounting or income tax withholding rules. Companies should seek expert legal and accounting advice before designing and implementing an equity-based compensation program.

Types of Equity-based Compensation

ESOPs and ESPPs

ESOPs

An employee stock ownership plan (ESOP) is a qualified retirement plan invested primarily in qualifying employer securities (generally, employer stock).¹ In addition to being a vehicle to provide equity compensation to employees in the form of retirement savings, ESOPs may also be a valuable financing tool for companies. ESOPs are often utilized by owner-operated businesses that desire to transfer ownership of the company to employees and may be referred to as an “employee-owned” company. ESOPs often involve a loan from a lender to purchase the qualifying employer securities held by the plan—this common type of ESOP is referred to as a leveraged ESOP.

An ESOP operates similarly to other types of defined contribution plans. Individual accounts of plan participants are credited with an amount of stock determined under either a discretionary or predetermined formula. The total value of the participant’s individual account is directly tied to the value of company stock.

As with other types of qualified retirement plans, an ESOP must meet specific requirements in order to preserve its tax advantage. The ESOP must satisfy the legal requirements applicable to all qualified retirement plans,² including nondiscrimination and minimum coverage rules. Since the nondiscrimination and minimum coverage rules apply, ESOPs may not be structured as management-only incentive plans. In addition to meeting the qualification requirements, an ESOP must be designed to invest primarily in employer securities. Participants must be allowed to exercise voting rights if the class of security provides voting rights. In addition to other distribution requirements, a participant who is entitled to receive a distribution from the ESOP is entitled to receive the benefit in the form of employer securities. Because an ESOP is a qualified plan, distribution events are limited.³

ESPPs

An employee stock purchase plan (ESPP) is a tax-favored arrangement that gives employees the opportunity to purchase company stock at a discounted price. Although not a qualified

retirement plan, an ESPP receives favorable tax treatment under the same legal framework that applies to statutory stock options (discussed below) as long as certain requirements are satisfied.⁴ If these requirements are met, the employee will not be required to recognize taxable income when the employee purchases stock under the plan (*i.e.*, exercise) and when the stock is later sold, it will be taxed as a capital gain. However, the statutory stock option holding period applies. If the employee sells the stock before the end of the holding period, then ordinary income will be recognized.

Under an ESPP, employees typically purchase stock through after-tax payroll deductions. On the purchase date, the company uses the accumulated deductions to purchase company stock for the individual, generally at a discount. The discount that may be offered to employees is the primary distinguishing feature of an ESPP. Depending on the specific plan design, the discounted price can be as much as 15% off the fair market value of the stock.⁵ From the employer’s perspective, the favorable tax treatment is one-sided. While the employee reaps a tax advantage, the employer cannot deduct a compensation expense as the result of the grant or the exercise of stock under an ESPP. A deduction is only available to the employer if the employee does not meet the holding period requirements and recognizes ordinary income.

Compensatory Stock Options

Options Generally

An “option” is a right granted to an individual to purchase company stock at a predetermined price or “exercise price.”⁶ The right to exercise the option (*i.e.*, purchase shares of stock) typically accrues or vests over a period of time and typically is subject to forfeiture if the employee leaves prior to the vesting date. Incremental vesting creates an incentive for the employee to remain with the company to reap the full value of the opportunity. The individual is under no obligation to purchase the stock. The basic components of an option are: (1) the offer to sell at the option price; (2) the maximum number of shares available to be purchased; and (3) the period of time the offer remains open.⁷ Option holders are not yet stockholders and, therefore, are not entitled to vote or otherwise exercise any other stockholder rights associated with ownership of stock. An important advantage of compensatory nondiscounted stock options (including incentive stock options, nonqualified stock options and performance-based stock options) is that they qualify for the performance-based pay exception from the Section 162(m) \$1 million limit on deductible compensation.⁸

1 See §§401(a), 4975(e) and 501(a) of the Internal Revenue Code of 1986, as amended (Code), and §407(d)(6) of the Employees Retirement Income Security Act of 1974, as amended (ERISA).

2 An ESOP must meet the qualification requirements of §401(a) of the Code as a defined contribution plan in order to secure the favorable tax treatment afforded to a qualified retirement plan, including deductibility of employer contributions, tax-free growth of trust and earnings, and delay of income taxation of participants until qualified distribution.

3 Typical distribution events are separation from service, death, disability or attainment of the plan’s normal retirement age. Additional distribution limitations apply to ESOPs that do not apply to other types of qualified retirement plans.

4 Generally, §423 requires the ESPP to be offered to employees with the same rights and privileges, be established pursuant to shareholder approval and comply with option price and option period restrictions. Code §423(b) and Treas. Regs. §1.423-2.

5 Code §§423(b)(6)(A) and (B).

6 Treas. Regs. §1.421-1(a).

7 Treas. Regs. §1.421-1(a)(1).

8 Code §162(m)(4)(C).

There are two basic types of compensatory stock options—statutory (commonly referred to as incentive stock options) and nonstatutory or nonqualified stock options.

Incentive Stock Options

Incentive stock options (ISOs) are tax-favored statutory stock options granted by a company to an employee to purchase stock of the corporation.⁹ A stock option must satisfy specific criteria to qualify as a tax-favored ISO.¹⁰ Among the fundamental criteria are the requirements that ISOs be granted to employees only and the exercise price be equal to or greater than the stock's fair market value on the grant date.¹¹

ISOs may have less flexibility but they also have two important advantages over nonstatutory stock options. First, neither the grant nor the exercise of the ISO triggers recognition of income or gain.¹² Second, if the stock purchased as the result of an ISO exercise is held until at least two years after the date of grant and one year after the date of exercise, gain on the sale of the stock will be capital gain not ordinary income.¹³ If stock purchased as the result of exercise of an ISO is sold prior to the expiration of that holding period, then ordinary income must be recognized if there is a gain.

The favorable tax treatment for the employee is offset by the loss of a tax benefit to the employer: an employer cannot deduct any compensation expense as the result of the grant or the exercise of an ISO.¹⁴ If, however, the employee does not meet the holding period requirements, the employer may deduct the compensation that the employee recognizes upon the exercise of the option.¹⁵

Nonstatutory Stock Options

The most common type of options issued to employees are nonstatutory stock options (NSOs), which are sometimes referred to as nonqualified stock options. An NSO is an option that does not satisfy the above requirements for ISOs. In contrast to ISOs, NSOs may be granted to *any* service provider, including non-employees, such as outside directors, independent contractors, etc. The exercise price of the NSO may also be less than the stock's fair market value on the grant date, but the granting of a so-called "discounted" NSO may have significant accounting and other tax ramifications.¹⁶ NSOs are governed by Section 83 of the Internal Revenue Code which covers the taxation of all property transferred in connection with the performance of services. Under Section 83(a), the grant of an NSO is not a taxable event except in very narrow circumstances discussed below. Typically, the taxation event for an NSO occurs when the option holder exercises the NSO, at which time the option

holder recognizes compensation or ordinary income (and, if the option holder is an employee, wages subject to withholding and employment taxes) equal to the fair market value of the stock transferred less the "strike" price paid on exercise of the option. Only in very narrow circumstances—where the option is fully vested and has a "readily ascertainable fair market value" on the date of grant—will the option be taxable upon grant.¹⁷

When unrestricted stock is transferred upon the exercise of an NSO and the employee recognizes compensation income equal to the difference between the fair market value of the stock on exercise and the exercise price, the employer is permitted to claim a corresponding business expense deduction under Section 162. Employers may deduct the amount only in the event the employee includes the amount in gross income.¹⁸

Performance-based Stock Options

Performance-based stock option plans may be broad-based or specific to one or a small group of executives. A performance-based stock option plan generally provides that the option holder will not vest and be eligible to exercise the NSO unless and until specified performance criteria are met. Examples of performance criteria might be the option price exceeding a predetermined incremental increase in value above the grant price or the company outperforming its financial projections. Typically, performance-based options operate by setting an exercise price that is above the current market value for the company's options. Consequently, it is only of value to the option holder if the market value increases above that threshold.

The rate of vesting of the performance-based options varies depending on the design of the program. Some common vesting schedules provide for graduated vesting upon the attainment of certain benchmarks in option price over grant price.

Restricted Stock

Restricted stock refers to a transfer of company stock that is subject to restrictions. Although the employee is treated as the owner of the stock when it is transferred, taxation is generally delayed until the rights in the stock are no longer subject to a "substantial risk of forfeiture" (*i.e.*, the rights are vested) or the stock is fully transferable. There is an exception to this tax treatment if a Section 83(b) election is made.¹⁹ A Section 83(b) election results in income recognition equal to the stock's fair market value on the date of grant, notwithstanding the potential that the stock may not vest and that the employee may forfeit the stock. Section 83(b) elections are irrevocable and must be made within 30 days of receiving a grant of restricted

9 Code §422(b).

10 Code §422 generally.

11 Treas. Regs. §§1.422-1 and 1.422-2(a).

12 Upon exercise, there may be alternative minimum tax implications to the employee depending on the excess spread between exercise price and fair market value. Code §56(b)(3).

13 Code §422(a)(1).

14 Code §421(a)(2).

15 Code §421(b).

16 In addition to receiving negative accounting treatment, a discounted option is treated as deferred compensation subject to the restrictions under §409A, which means that the option generally must have a fixed exercise date.

17 Treas. Regs. §1.83-7.

18 Treas. Regs. §1.83-6(a)(1).

19 Under §83(b) of the Code, an election may be made to recognize income upon the transfer of restricted property (not yet vested) paid in connection with the performance of services.

A performance-based stock option plan generally provides that the option holder will not vest and be eligible to exercise the NSO unless and until specified performance criteria are met.

stock.²⁰ If a Section 83(b) election is made, the tax event is accelerated for both the employee and the employer. The employee includes the current fair market value of the stock in income upon grant and the employer deducts the value of the stock includable in the employee's income. The benefit of a Section 83(b) election is that the compensatory element of the transaction is closed and any future appreciation in the stock may be eligible for capital gains tax treatment when the stock is later sold.

If a Section 83(b) election is not made, the employee's tax holding period begins at the time of vesting, and the employee's tax basis is equal to the amount paid for the stock (if any) plus the amount included as ordinary compensation income. Upon a later sale of the shares, assuming the employee holds the shares as a capital asset, the employee would recognize capital gain income or loss; whether such capital gain would be a short- or long-term gain would depend on the time between the beginning of the holding period at vesting and the date of the subsequent sale.

An employer deduction is allowed under Section 162 when the employee includes the amount in income. Employers may deduct amounts in the employer's taxable year in which the employee's taxable year ends.²¹

Phantom Rights

The equity-based compensation options discussed above involve actual shares of stock and may not be the first choice for all employers. Implementation costs, the burden of regulatory requirements, such as securities laws registration, valuation challenges or corporate structure may incite employers to adopt plans that provide cash awards rather than share ownership. Additionally, the company's owners may simply prefer to share in the economic value of equity but not the *actual* equity. For these employers, phantom equity-based compensation alternatives may be more attractive.

Phantom Stock

Phantom stock is an employer's promise to pay a bonus to the employee equal to the value of its stock on a future date. The amount of the payment is determined by measuring the value of company stock on a specified grant date and the increase in value over a specified period of time. Several key features of phantom stock, which distinguish it from stock appreciation rights, are that the employee generally receives the stock value even if the stock price does not increase from the date

of grant and phantom stock value may reflect dividends and stock splits.

In addition, in contrast to SARs, phantom stock typically does not permit the employee to cash out the value during the period. Rather, the phantom stock value is generally paid at a predetermined future date and subject to claims of the employer's creditors to avoid earlier income inclusion under the constructive receipt and economic benefit doctrines.

Stock Appreciation Rights

A stock appreciation right (SAR) is similar to an option because SARs typically provide for the right to receive the cash equivalent of the appreciation in the value of a predetermined number of shares over a set period of time. Employers have more flexibility in SAR plan design than in phantom stock plan design. Some plans permit the employee to cash out the appreciated value at any time while other plans require a set period of time to elapse. On the date of grant, the SAR has no spread or ascertainable value.²² Like phantom stock, the rights are typically paid out in cash but may be settled in stock (or a combination of cash and stock).

Payments received to cash in stock appreciation rights are includible in gross income in the year the employee exercises the rights.²³ Exercising the right to receive employer stock instead of cash also results in income to the employee. A payment in cash is deductible once the employer actually pays for the exercise of the SAR. If the employer distributes stock for the SAR, the value of the stock is deductible once that stock is distributed.

Restricted Stock Units

Restricted stock units (RSUs) are similar to restricted stock, but the compensatory grant under an RSU is merely valued in terms of company stock and does not provide for an actual transfer of company stock at the time of the grant. It may be useful to think of an RSU as a promise to transfer stock (or make an equivalent cash payment) in the future. Depending on the specific terms of the award, RSUs may be settled in either cash or actual shares after the vesting requirements are satisfied. Upon transfer, the value of the stock (or equivalent cash) is included in the employee's income and taxable as wages. Note that the vesting date and the transfer date may not be the same (*i.e.*, some RSUs may "vest" the employee in a right to a future transfer.)

20 Code §83(b).

21 Code §83(h).

22 The value of the rights should be limited to the spread between the date of grant and the date of exercise to avoid constructive receipt. Private Letter Rulings 8925024, 8831031, 8513047, 8333079, 8316044, 8252053 and 8117078.

23 Rev. Ruls. 82-121 and 80-300.

Summary of Tax Treatment*

Type of Equity-based Compensation	When is it Taxable to the Employee?	When is the Deduction Taken by the Employer?
ESOP	<ul style="list-style-type: none"> No tax on earnings No tax at time of contribution Tax upon distribution 	<ul style="list-style-type: none"> In a leveraged ESOP, loan repayments (principal and interest) are deductible when paid Otherwise, contributions to the ESOP are deductible when made
ESPP	<ul style="list-style-type: none"> No tax at grant of option No tax at exercise of option* <p>* Holding period applies. Employee may not sell the share within two years from grant and one year from date of exercise or income must be recognized similar to NSOs.</p>	<ul style="list-style-type: none"> No deduction unless the employee fails to satisfy the holding period
Incentive Stock Options	<ul style="list-style-type: none"> No tax at grant of option No tax at exercise of option* <p>* Holding period applies. Employee may not sell the share within two years from grant and one year from date of exercise or income must be recognized similar to NSOs.</p>	<ul style="list-style-type: none"> No deduction unless the employee fails to satisfy the holding period
NQ Stock Options	<ul style="list-style-type: none"> Except in rare cases, taxation upon exercise and the receipt of stock that is no longer subject to a substantial risk of forfeiture 	<ul style="list-style-type: none"> Generally deductible during the same year employee recognizes income
Performance-based Stock Options	<ul style="list-style-type: none"> Taxation upon exercise and the receipt of stock that is no longer subject to a substantial risk of forfeiture 	<ul style="list-style-type: none"> Generally deductible during the same year employee recognizes income
Restricted Stock	<ul style="list-style-type: none"> Taxed when no longer subject to a substantial risk of forfeiture Section 83(b) election available 	<ul style="list-style-type: none"> Generally deductible during the same year employee recognizes income
Phantom Stock	<ul style="list-style-type: none"> Taxed in the year value of shares is paid 	<ul style="list-style-type: none"> Generally deductible during the same year employee recognizes income (but may be deductible in the tax year prior to vesting if paid out within 2-1/2 months of the close of the year)
Stock Appreciation Rights	<ul style="list-style-type: none"> Taxed in the year right is exercised and cash or stock received 	<ul style="list-style-type: none"> Generally deductible during the same year employee recognizes income (but may be deductible in the tax year prior to vesting if paid out within 2-1/2 months of the close of the year)
Restricted Stock Units	<ul style="list-style-type: none"> Taxed when cash or stock is transferred to employee 	<ul style="list-style-type: none"> Generally deductible during the same year employee recognizes income (but may be deductible in the tax year prior to vesting if paid out within 2-1/2 months of the close of the year)

* This chart summarizes general rules relating to the income tax treatment of certain categories of equity-based compensation and is not intended to be an exhaustive list. Exceptions and timing differences may exist based on plan design.

One important difference between RSUs and restricted stock is the option to include in income the fair market value of the stock prior to vesting. A Section 83(b) election is not available upon the grant of an RSU because there is no actual transfer of stock on the grant. An award of restricted stock units is not a current transfer of property; therefore, there is no income event until there is an actual transfer of cash or fully vested stock.

In Conclusion—On the Horizon

As with all forms of compensation, rules and regulations change over time. The following are a few of the regulatory changes impacting equity-based compensation in the near future.

Section 409A

Section 409A governing deferral of compensation was added to the Internal Revenue Code effective January 1, 2005. Final regulations were issued in 2007 and after several extensions, the final deadline for compliance is December 31, 2008.²⁴ Under the final regulations, the following types of equity-based compensation are subject to Section 409A: nonstatutory stock options or stock appreciation rights that have an exercise price below fair market value on the date of grant or



24 Notice 2007-86; Treas. Regs. §1.409A-6.

25 Note that the definition of fair market value for purposes of §409A is more restrictive than the definition of fair market value under §422 of the Code relating to ISOs.

26 Prop. Regs. §1.6039-1.

To date, more than 100 countries require, permit or base their standards on IFRS.

that include a deferral feature; restricted stock units that are not paid upon vesting (or within 2 1/2 months of the close of the tax year of vesting); and options to acquire (or stock appreciation rights based on) stock that does not constitute service recipient stock as defined by Section 409A. The terms “fair market value” and “service recipient stock” are complex definitions specific to Section 409A²⁵ and must be considered when determining whether equity-based compensation will be treated as a deferral of income. These types of equity-based compensation must be reviewed and, if necessary, revised to comply with the Section 409A requirements. The good news is that there are some specific exceptions employers may take advantage of if applicable.

Failure to comply with Section 409A at any time during a taxable year may cause the amounts deferred under the plan for that year (and all preceding taxable years) to be included in the participant’s gross income in the taxable year in which the failure occurred to the extent vested. Additionally, these amounts are subject to a 20% addition to tax plus interest at an increased rate on any resulting tax underpayments.


IFRS

On August 27, 2008, the US Securities and Exchange Commission announced the proposal of a roadmap for mandatory adoption of International Financial Reporting Standards (IFRS) in place of US Generally Accepted Accounting Principles (GAAP) in 2014, 2015 or 2016 (depending on the size of the company) with an early adoption option available in 2009 for some large companies who meet specific criteria. To date, more than 100 countries require, permit or base their standards on IFRS. Implementing a single set of high quality, globally accepted accounting standards would benefit global capital markets and investors by simplifying comparisons among global investment opportunities (regardless of where a company is located) and would also benefit companies by eliminating duplicative and costly reporting requirements. From a US standpoint, the conversion to IFRS will have a profound impact on equity-based executive compensation, in addition to other changes. For example, employee stock purchase plans that do not currently have to record an expense under the United States GAAP rules will have to now record a compensation expense under IFRS.

Proposed Regulations under Section 6039

In July of 2008, the IRS issued proposed regulations relating to the return and information statement requirements under Section 6039.²⁶ The proposed regulations reflect the changes to Section 6039 made by the Tax Relief and Health Care Act of 2006. The proposed regulations provide guidance to assist corporations with the return and information statement requirements related to ISOs and ESPPs. The new regulations establish four sets of requirements concerning:

- returns filed with the IRS related to ISOs;
- returns filed with the IRS related to ESPPs;
- statements to participants related to ISOs; and
- statements to participants related to ESPPs.

The effective date for the new requirements is January 31 following the year of the stock transfer. IRS Notice 2008-8 waived the new requirements for 2007 and 2008 extending the compliance deadline to 2009. 

Note: The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP.



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