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Tax Risks of Equity-Based Compensation

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This practice note provides an overview of certain tax issues associated with grants of equity-based compensation. The desire to attract and retain key employees is an enduring objective of most businesses, whether publicly traded or private. While some employees may value bringing their dog to work, free fitness classes, or organic homecooked meals twice a day, there is no more favored employee benefit than an offer of equity ownership. Too often, however, both employers and their employees fail to fully appreciate the tax risks of equity-linked compensation. The following discussion reviews the relevant tax treatment and highlights key tax-related considerations for executive compensation attorneys to address with their corporate clients who offer equity to their employees and with their executive clients who may receive equity grants as part of their total compensation package.

This practice note covers:

- Importance of Understanding the Taxation of Equity-Based Compensation
- Where It All Begins – Section 83
- Taxation of Restricted Stock, Stock Options, and Other Equity-Based Compensation
- Selected Tax Issues for Equity Grants

For additional commentary on this subject, see Equity and Incentive Compensation Arrangements for Employees of Startup Companies, Understanding, Drafting, and Negotiating Executive Compensation Agreements on Behalf of Employers, Understanding, Drafting, and Negotiating Executive Compensation Agreements on Behalf of Executives, and Understanding Types and Taxation of Equity Compensation.

Importance of Understanding the Taxation of Equity-Based Compensation

There is nothing particularly surprising about the long-standing use of equity-linked compensation to align the financial interests of key employees with the company and its shareholders. This is especially true when cash is short but stock value is long. Granting restricted stock, stock options, and other types of equity awards is a timehonored and inexpensive way to supplement cash compensation as well as attract and retain top talent.

Restricted stock, incentive stock options, and nonqualified stock options remain the primary form of equity-linked incentive compensation offered to highly valued current and prospective employees. As discussed in the following sections, the tax consequences and restrictions vary among each of these and other alternatives. The fundamental failure to understand these differences can lead not only to significant tax problems for the employee, but also may significantly damage the corporation's brand and the goodwill it desires to establish with its employees. Even the best of intentions can result in lawsuits and mutual recriminations arising from an inexpertly drafted incentive compensation agreement. Both the employee's and employer's advisors must be aware of the risk parameters to avoid the financial and reputational harm that can arise from a poorly drafted equity-linked compensation arrangement.

Where It All Begins – Section 83

Section 83 of the Internal Revenue Code (Section 83) establishes the general income tax rules for transfers of property to an employee in connection with the performance of services (e.g., grants of restricted stock in exchange for services provided or future services). Note that the Section 83 principles apply even if property is transferred to an employee by a transferor other than the employer (such as a company shareholder) and for service providers other than employees (such as independent contractors). 26 C.F.R. §§ 1.83-1(a), 1.83-6(d).

Section 83 General Rules

Section 83 property is generally taxable to the employee at the time the property is or becomes substantially vested to the extent that:

- The fair market value of the property at the time of transfer (ignoring any lapse restriction), over
- The amount, if any, paid for such propertyI.R.C. § 83(b)(1); 26 C.F.R. § 1.83(a)-2(a).

For purposes of Section 83, property is substantially vested when it is no longer subject to a substantial risk of forfeiture (within the meaning of 26 C.F.R. § 1.83-3(c)). 26 C.F.R. § 1.83-1(a). And property is subject to a substantial risk of forfeiture if the employee's rights in the property are conditioned on the future performance of services (or, in certain circumstances, refraining from performing services pursuant to a non-compete agreement). I.R.C. § 83(c)(1); 26 C.F.R. § 1.83-3(c). For a discussion comparing the substantial risk of forfeiture concept under various provisions of the Internal Revenue Code, see Substantial Risk of Forfeiture.

A lapse restriction is any limitation on the holder's right to transfer the property that is not permanent, including a forfeiture provision. 26 C.F.R. § 1.83-3(i).

Section 83(b) Elections

Under Section 83(a)'s general rule, income is not included for a compensatory transfer of property until the property is vested. However, pursuant to Section 83(b), an employee who receives property in exchange for services may irrevocably elect to include an amount in income for the tax year in which the property is transferred, instead of a later year when it becomes vested. In that case, the income inclusion amount is the excess of:

- The fair market value of the property at the time of transfer (ignoring any lapse restriction), over
- The amount, if any, paid for such property I.R.C. § 83(b)(1); 26 C.F.R. § 1.83(a)-2(a).

The Senate Report accompanying the bill that added Section 83(b) explained its reasoning as follows:

To add flexibility, the committee adopted a provision allowing recipients of restricted property the option of treating it as compensation in the year it is received, even though it is nontransferable and subject to a substantial risk of forfeiture. If this election is made, the restricted property rules are not to apply, and later appreciation in the value of the property is not to be treated as compensation. However, if the property is later forfeited, no deduction is to be allowed with respect to the forfeiture. S. Rept. 91-552 (1969), 1969-3 C.B. 423, at 502.

Thus, a Section 83(b) election allows an employee receiving restricted stock, for example, to effectively convert all post-grant appreciation from compensation income to capital gain income, including appreciation from the grant date through the vesting date. Indeed, courts have indicated that it is the sole means of doing so. Alves v. Comm'r, 79 T.C. 864, 877 (1982), aff'd, 734 F.2d 478 (9th Cir. 1984). Note that, in addition to accelerated income inclusion,

the Section 83(b) election causes the holding period for the property to begin at the transfer date, rather than from the vesting date for characterization as a short- or long-term capital gain. 26 C.F.R. § 1.83-4(a).

Section 83(b) Election Requirements

A Section 83(b) election must contain each of the following elements:

- The name, address, and taxpayer identification number of the taxpayer
- A description of each property with respect to which the election is being made
- The date or dates on which the property is transferred and the taxable year for which the election is being made
- The nature of the restriction(s) to which the property is subject
- The fair market value at the time of transfer (determined without regard to any lapse restrictions) of each property with

respect to which the election is being made

- The amount, if any, paid for the transferred property –and–
- A statement to the effect that copies of the election have been furnished to the employer (and, when the service provider is not the transferee of the property, to the transferee) 26 C.F.R. § 1.83-2(e).

The Section 83(b) election must be filed with the Internal Revenue Service (IRS) within 30 days after the date the property is transferred, and may be filed prior to the transfer date. A change to the regulations eliminated for transfers occurring on or after January 1, 2016, the earlier requirement that a copy of the Section 83(b) election be submitted with the taxpayer's income tax return for the taxable year in which the property is transferred. 26 C.F.R. § 1.83-2(c); T.D. 9779, 81 Fed. Reg. 48,707 (July 26, 2016).

Taxpayers making a Section 83(b) election must maintain records identifying the basis of property received in the transfer, the original cost, if any, of the property and records supporting the tax treatment of the property transfer as reported on the taxpayer's return. These records and a copy of the Section 83(b) election must be kept until the period of limitations expires for any return with respect to which the income inclusion or basis of the property is relevant. T.D. 9779, 81 Fed. Reg. 48,707–08.

For further discussion on making Section 83(b) elections, see the section entitled "Deciding Whether to Make a Section 83(b) Election" under Selected Tax Issues for Equity Grants below. For a sample Section 83(b) election, see Section 83(b) Election Form (Restricted Stock).

Employer Deduction

The corollary to I.R.C. §§ 83(a) and (b) is I.R.C. § 83(h), which allows the employer to deduct a compensation expense corresponding to the compensation income reported by the employee in the same year as the income is recognized. For large companies that make frequent and sizeable equity grants, the value to the employer of that noncash deduction can be substantial. For example, Facebook, Inc.'s Form 10-Q for June 30, 2012, reported a share-based compensation expense of $1.2 billion.

Applying Section 83

Determining how much and when an employee receives compensation under Section 83 is often not straightforward. In fact, what may seem clear to both employer and employee on the grant date may be disputed even a short time later. The consequence of not timely confirming the economic expectations of the parties is illustrated by Theophilos v. Comm'r, 1994 Tax Ct. Memo LEXIS 47, T.C. Memo 1994-45 (T.C. 1994), rev'd, 85 F.3d 440 (9th Cir. 1996). In particular, Theophilos demonstrates the importance of confirming both the time when property is received as well as the value of the property received.

Theophilos v. Comm'r

In Theophilos, the taxpayer (Anthony Theophilos) was the attorney for a corporation that had a single owner, George Beegle. Because Theophilos desired to become a stockholder of Beegle's corporation, they entered into a complex transaction initially requiring the recapitalization of Beegle's stock into Class A and Class B shares. The April 1986 recapitalization was intended to freeze the value of the Class A stock and limit the holder of Class B stock to participation solely in future profits. That limitation acted to depress the fair market value of the Class B stock when acquired by Theophilos, thereby minimizing his out-of-pocket economic cost for the shares and eliminating any potential Code Section 83(a) tax consequence since he paid for the shares based on this valuation.

In support of the Class B stock valuation, an appraisal issued a few weeks before the stock transfer stated that the value of the class B common stock was nominal and represented a minority position with no significant decisionmaking authority. In December 1986, Theophilos paid $10,000 for 1,202 Class B shares, which was consistent with the fair market value of those shares as determined by the appraisal. On his 1986 tax return, he did not report any income associated with his purchase of the Class B stock (assuming there was no excess value over the amount paid). The corporation did not report on Form W-2 any compensation from the purchase. The corporation also did not claim a deduction for compensation paid in connection with the purchase of the shares.

Less than a year after Theophilos acquired the Class B stock, he resigned from the company following a series of disagreements with Beegle. Theophilos then sought to have the corporation redeem his Class B stock in accordance with the shareholder agreement, which Beegle challenged. In April 1989, the parties entered into a settlement agreement wherein the corporation agreed to pay Theophilos a special termination bonus of $1.75 million.

In early 1990, the corporation obtained another appraisal of the Class B stock's December 1986 value. The new appraiser determined that the fair market value of Theophilos' Class B shares was $3,526,320. Beegle then had the corporation issue Form W-2c, Statement of Corrected Income and Tax Amounts, to Theophilos for the 1986 tax year retroactively increasing his compensation by $3,516,320 (properly acknowledging the $10,000 paid for the shares). The corporation also amended its 1986 tax return to report a deduction for the revised compensation expense. The IRS adjusted Theophilos' 1986 income tax to reflect the additional compensation reported in Form W2c.

On review, the U.S. Tax Court identified the primary issue under Section 83 as the time when Theophilos acquired a beneficial interest in the Class B stock and the value of the stock on that date. Theophilos argued that he acquired a beneficial interest in the Class B stock in 1985, when he and Beegle agreed upon an outline of the terms of his prospective employment with the company, or on an intervening date when the final terms were determined or documented, well before the shares in question were paid for and formally transferred to him. The court rejected that argument, focusing instead on when Theophilos acquired a beneficial ownership interest in the property. This did not occur, said the court, until he paid for and acquired the shares. 1994 Tax Ct. Memo LEXIS at *34–*43. (Of small consolation to Theophilos, the court also reduced the appraised value of the Class B stock to $2,366,479. Id. at *49.)

On appeal, the Ninth Circuit Court of Appeals reversed the Tax Court. There, Theophilos again asserted that the time of payment for and transfer of the Class B stock occurred at the time he was obligated to purchase the shares. According to Theophilos, he purchased the shares in April 1986 when he was contractually obligated to acquire them. Challenging that assertion, the IRS argued that, prior to the time when payment was tendered and the Class B shares transferred, Theophilos possessed nothing more than an option to acquire the shares, which was not exercised until December 1986.

The term property, for purposes of Section 83, is defined to include "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." 26 C.F.R. § 1.83-3(e). Interpreting that regulation, the reviewing court said a "contractual right to acquire stock is not unsecured or unfunded if it is a binding obligation secured by valuable consideration" and "a contractual obligation to acquire stock, as well as an acquisition of stock itself, is 'property' within the meaning of I.R.C. § 83, and if the contractual right to acquire stock is taxable under § 83, the subsequent purchase of the stock is not." 85 F.3d at 444–45.

The court concluded that the parties entered into a binding agreement in April 1986 establishing Theophilos' right to acquire a specified amount of the Class B stock at a designed time for a fixed price, which right was not subject to a substantial risk of forfeiture. In reaching its conclusion, the court noted that the corporation's failure to claim a $3.5 million compensation deduction until more than three years later "clearly suggests that in 1986 [the corporation] thought the transaction was a fair market value exchange which would generate no tax benefits for the company." Id. at 448–49. Therefore, regardless of the fair market value of the Class B stock in December 1986, the shares Theophilos agreed to purchase in April 1986 had a value of $10,000, which equaled the amount he paid for the shares.

Theophilos illustrates the importance of clearly establishing the economic expectations of the parties early on in equity grant discussions. While later disagreements and regrets may be inevitable, they need not result in a change to the expected tax consequences.

Observations on Theophilos

The grant of an equity interest and the terms of separation in Theophilos would have been far simpler had limited liability companies (LLCs) been available when Beegle started his business. On January 1, 1997, the IRS issued the check-the-box regulations providing authoritative guidance for how the federal government would classify both single and multi-member LLCs. These regulations greatly accelerated the use of LLCs as a preferred form of organization for private businesses.

As a result, it is now possible to achieve the exact economic result desired in Theophilos—granting an equity interest representing a share of future increases in enterprise value without incurring any current tax liability— without the complexity added by a recapitalization or the need for an appraisal by combining the guidance provided by Rev. Proc. 93-27, 1993-27 C.B. 343, and Rev. Rul. 99-5, 1991-1 C.B. 434.

Under this guidance, the IRS will not treat the grant of a profits interest providing an equity interest in the future profits and future growth of an LLC as a taxable event (even if the interest is vested on the grant date) if the profits interest does not relate to a substantially certain and predictable stream of income from the LLC's assets, the grantee does not dispose of the profits interest within two years of grant, and the LLC is not a publicly traded partnership. For purposes of such grants, the LLC's operating agreement can provide that, as of the grant date, the net proceeds from a hypothetical liquidation will only be distributed in accordance with the positive capital account balances of the LLC members. Alternatively, the operating agreement can provide for a "distribution threshold" or similar hurdle restricting the profits interest holder's right to receive any proceeds over a hypothetical liquidation value determined as of the profits interest grant date. For more information, see Understanding Partnership and LLC Equity Compensation.

Ironically, Theophilos had written a message to Beegle at the outset of their negotiations proclaiming, "We're going to be partners!" If only they had actually been partners instead of co-shareholders, the outcome may have been very different.

Taxation of Restricted Stock, Stock Options, and Other Equity-Based Compensation

This section reviews basic tax concepts for granting compensatory restricted stock, stock option, and other equitybased awards to employees and other service providers.

Restricted Stock

The grant of restricted stock (i.e., shares that are subject to time vesting, performance vesting, or both) to an employee as incentive compensation is typically not complicated from a Section 83 perspective. As described above, the general rule is that restricted stock is not taxable to the employee until it has been transferred and is substantially vested. 26 C.F.R. § 1.83-1(a). However, the tax timing can be accelerated if the employee makes a Section 83(b) election for taxation upon transfer.

The treatment of compensatory stock options is more complicated, as discussed below.

Compensatory Stock Options

A corporation may grant either qualified stock options (QSOs) or nonqualified stock options (NQSOs) to its employees. A QSO (also referred to as a statutory option) may be offered in one of two varieties: either through an employee stock purchase plan (ESPP) qualified under I.R.C. § 423 or, more commonly, as an incentive stock option (ISO) qualified under I.R.C. § 422. Any stock option that is not qualified under Sections 422 or 423 is an NQSO.

Qualified Stock Options

QSOs have long been a favored form of option because the grantee does not report any income either at the time granted or when subsequently exercised. Instead of, and in contrast to, the general rule of Section 83, a QSO is taxable when the employee disposes of the underlying stock acquired by exercising the option (although it should be noted that an ISO may be subject to alternative minimum tax (AMT) upon exercise). I.R.C. § 421(a). QSO Holding Periods and Qualifying Dispositions

if, after exercise of a QSO, the grantee holds the employer's stock through the later of (1) the two-year period beginning on the grant date, and (2) the one-year period beginning on the date the option is exercised and the shares are transferred to the employee, the tax treatment is as follows:

- For ISOs, any gain in value in excess of the exercise price of the stock option is generally taxed as a long-term capital gain upon disposition (and any loss is treated as a capital loss).
- For ESPP shares, the employee recognizes ordinary income to the extent of the lesser of (1) the excess of the grant date fair market value over the exercise price (i.e., the inherent value on the grant date) or (2) the excess of the fair market price at the time of disposition over the amount paid for the shares, with any further gain treated as a short- or long-term capital gain. I.R.C. § 423(c).

If the grantee does not satisfy the holding period requirement described above, the result is a disqualifying disposition, which dramatically changes the economic consequences for both the employee and the employer, as discussed below. 26 C.F.R. § 1.422-1(a)(1)(A).

<u>Disqualifying Dispositions of QSOs</u>

Employees who engage in a disqualifying disposition do not obtain the tax benefit of an ISO (beyond the tax deferral to the date of disposition). In the year of a disqualifying disposition:

- For ISOs, an employee will have ordinary income (although without a withholding requirement), and the employer will have a corresponding compensation deduction, equal to the spread at the time of exercise. I.R.C. § 421(b). The employee will also have capital gain income on an amount equal to the excess (if any) of the sale price over the employee's basis in the shares (determined as the sum of the exercise price and the gain on the shares through the exercise date). However, if the selling price of the shares is less than the fair market value of the shares on the exercise date, the income reported by the employee (and the corresponding deduction for the employer) is limited to the excess of the amount realized on the sale over the exercise price. I.R.C. § 422(c)(2); 26 C.F.R. § 1.422-1(b)(2)(i). See the example below.
- For ESPP shares, the excess of the fair market value of the shares on the exercise date over the exercise price is treated as ordinary income (although without a withholding requirement), even if no gain (or a loss) is realized on the sale, with any further gain treated as a short- or long-term capital gain. If the shares are sold for less than fair market value as of the exercise

date, the employee recognizes the same amount of ordinary income and will have a capital loss equal to the difference between the sale price and the exercise date fair market value.

Example (disqualifying disposition of ISO). On June 1, 2015, ABC Corp. granted an ISO to Joan, an ABC employee. The grant provided Joan with the right to purchase 1 share of ABC stock at an exercise price of $100 (fair market value as of the grant date). On August 1, 2015, Joan exercised the option and received the stock when the fair market value of a share of ABC stock was $200.

On September 1, 2016, Joan sells her share of ABC stock for $250 (a disqualifying disposition because it occurred prior to the expiration of the two-year period beginning on the grant date, even though the disposition occurred more than one year after the share was transferred to her).

Joan's spread on the exercise date is $100, which is the difference between the fair market value of the share when transferred to her ($200) and the amount she paid for the share upon exercise ($100). Because the amount Joan received on the sale of the share ($250) is greater than the fair market value of the share when transferred to her ($200), the exception to the rule described above does not apply.

For 2016, Joan includes $100 in income as compensation and $50 as capital gain (the amount realized from the sale ($250) less Joan's adjusted basis of $200 (the $100 paid for the share plus the $100 increase in basis increase resulting from the inclusion of compensation attributable to the exercise of the option)). ABC's deduction is limited to the $100 of compensation attributable to Joan's exercise of the option. See 26 C.F.R. § 1.422-1(b)(3), Example 1.

<u>QSO Requirements</u>

There are significant limitations on the amount of QSOs that can be offered to a single individual. For purposes of ESPPs, no employee may be granted an option that allows for the right to purchase more than $25,000 of the employer's stock (determined as of the grant date) during any calendar year that the option is outstanding. I.R.C. § 423(b)(8); 26 C.F.R. 1.423-2(a)(3)(vi). Likewise, for ISOs, purchases of the employer's stock are limited to no more than $100,000 of stock (determined as of the grant date) during any calendar year. I.R.C. § 422(d)(1); 26 C.F.R. § 1.422-4.

Options granted under an ESPP generally must be offered to all full-time employees with at least two years of service (except for certain highly compensated employees). The nondiscrimination requirement, as well as the low stock value threshold, greatly reduces the general enthusiasm for ESPPs as a compensatory tool.

Although ISOs may be granted on a discriminatory basis, allowing for the targeting of one or a limited set of officers and highly compensated employees, the price for doing so is strict compliance with the ISO rules. Specifically, to qualify as an ISO each of the following requirements must be satisfied, in addition to the $100,000 limitation noted above:

- ISOs must be granted under a shareholder-approved plan and within 10 years from the date the underlying plan is adopted or approved by the shareholders, whichever is earlier.
- ISOs must not be exercisable more than 10 years from the grant date (or not more than five years for grantees who are 10% owners).
- The exercise price must not be less than the fair market value of the stock on the grant date (and not less than 110% of the fair market value for grantees who are 10% owners). This contrasts with ESPP shares which are permitted to be purchased at a discount of up to 15% off the grant date fair market value.
- ISOs may not be transferred by the employee other than by will or the laws of descent and distribution, and may be exercised, during the employee's lifetime, only by the employee.
- The grantee must not own stock possessing more than 10% of the total combined voting power of all classes of stock of the employer or its parent or subsidiary corporation when the option is granted.

More information on QSOs can be found in Incentive Stock Option Checklist Considerations and Developing Qualified Employee Stock Purchase Plans.

Nonqualified Stock Options

An NQSO is merely a contract right entitling an employee (or other service provider) the opportunity to acquire a fixed amount of her employer's stock at a set price over a specified period of time. The tax consequences of an NQSO, however, vary greatly from the tax consequences of a QSO. In contrast to a QSO, an NQSO does not need to be granted pursuant to a plan, is not subject to discrimination or annual purchase restrictions, and can be exercised over any term limited only by the grant agreement. The question remains: does Section 83(a) apply to an NQSO?

As discussed earlier, for Section 83 purposes, property is defined to include real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. 26 C.F.R. § 1.83-3(e). Therefore, whether Section 83 applies to the grant of an NQSO turns on whether the NQSO is property, which according to the Section 83 regulations depends on whether the NQSO has a readily ascertainable fair market value on the grant date:

- If an NQSO has a readily ascertainable fair market value at the time the option is granted, it is subject to Section 83 at the time of grant. In that case, the employee holding the NQSO would be subject to tax on the option's spread or intrinsic value in the tax year in which the option becomes substantially vested (or the year of grant, if the option is vested on grant), as opposed to the tax year in which the option is exercised. In practice, NQSOs rarely have a readily ascertainable value, as discussed below.

- If an NQSO does not have a readily ascertainable fair market value at the time the option is granted (which is usually the case), Section 83 does not apply until the option is exercised or otherwise disposed of, even if the fair market value of the NQSO becomes readily ascertainable after the grant date but before the exercise date. 26 C.F.R. § 1.83-7(a). In that case, the employee would not be subject to tax on the option's spread or intrinsic value at the time the option becomes substantially vested. 26 C.F.R. § 1.83-7(b).

There are two tests for determining whether an NQSO has a readily ascertainable fair market value. Under the first test, an NQSO has a readily ascertainable fair market value if the option is actively traded on an established market, which is atypical in the context of an NQSO granted to an employee. 26 C.F.R. § 1.83-7(b)(1). The second test provides that an NQSO has a readily ascertainable fair market value if all of the following conditions are satisfied on the grant date:

- The option is transferable by the optionee.

- The option is exercisable immediately in full by the optionee.

- The option or the property subject to the option is not subject to any restriction or condition that has a significant effect upon the fair market value of the option.

- The fair market value of the option privilege (i.e., the ability to benefit from the option during the exercise period without putting any capital at risk) is readily ascertainable in accordance with 26 C.F.R. § 1.837(b)(3). 26 C.F.R. § 1.83-7(b)(2).

For a typical employee, the second test is no more likely to be satisfied than the first. The primary purpose of granting an NQSO is to attract and retain talent by aligning an employee's financial interests with the interests of the employer's shareholders. If the option is fully transferable, immediately exercisable, or unrestricted on the grant date, that purpose would be easily defeated. Additionally, satisfying the regulation's tests would subject the employee to tax on the value of the option when it becomes substantially vested (as in the case of restricted stock) rather than upon exercise, which is clearly not consistent with the intended economic benefit. In any event, the regulation provides clear guidance for drafting an NQSO that does not have a readily ascertainable fair market value. Of course, sometimes unanticipated events can derail even the best of intentions, as illustrated by the case discussed below.

<u>Cramer v. Comm'r</u>

In Cramer v. Comm'r, 64 F.3d 1406 (9th Cir. 1995), the court considered the tax consequences for directors of a private corporation who sold their unexercised compensatory NQSOs to a third-party acquirer of the company. The primary issue was whether the gain on the sale of the NQSOs was ordinary income or long-term capital gain based on the tax timing rules of Section 83.

In order to preserve the possibility of receiving capital gain treatment at the time of a future disposition, each director made a Section 83(b) election, although that position was in tension with the Treasury Regulations since, among other things, the NQSOs were issued with specific vesting and transfer restrictions. The Section 83(b) elections stated that the fair market value of the options on the grant date was zero, although none of the directors consulted a qualified appraiser before claiming the options had no value.

Approximately two years after the option grant and Section 83(b) elections, an independent buyer acquired all of the corporation's stock for $163 per share. The buyer also purchased all of the outstanding vested and unvested options for $163 less the applicable option exercise price. Each director received several million dollars for his vested and unvested options.

The directors generally reported their income from the option sales as long-term capital gain. Also, two of the directors reported a significant tax basis in their options, contrary to what was reported in their Section 83(b) elections. On audit, the IRS characterized the amounts from the option sales as ordinary income, and imposed deficiency and penalty assessments.

The directors appealed, but the Tax Court sided with the IRS, concluding that the vesting and transfer restrictions prevented the options from having a readily ascertainable fair market value at the time of grant. As a result, since the options were not subject to

Section 83 until exercise (or other taxable transfer), the Tax Court affirmed that the sale proceeds were not eligible for capital gains treatment.

At the Ninth Circuit Court of Appeals, the directors asserted that the options had a readily ascertainable fair market value on their respective grant dates. What followed, they argued, was that (1) Section 83(a) applied to all of the options at the time of grant, (2) the Section 83(b) elections were valid, (3) the directors recognized ordinary income to the extent of the spread of each option as of the grant date, and (4) any subsequent appreciation was taxable as long-term capital gain when the options were sold. Since the options were not actively traded on an established market, the Ninth Circuit analyzed the directors' assertion by applying the four tests of 26 C.F.R. § 1.83-7(b)(2). In upholding the Tax Court's decision, the court did not address the fourth test since the options clearly failed the first three. Cramer, 64 F.3d at 1412.

Cramer highlights important tax concerns underlying the grant of NQSOs. First, an at-the-money option will not have a readily ascertainable fair market value if the option is not traded on an established market (which is extremely rare for options granted to employees). Likewise, an option that has transfer or vesting restrictions (the absence of which is unusual for employee options) also will not have a readily ascertainable fair market value, which is a statutory concept not a valuation driven determination. As a result, nearly all employee-granted NQSOs are nothing more than an unfunded and unsecured promise to pay money or property in the future, which are not taxable until exercise or other taxable transfer.

Second, because a typical NQSO is not classified as property for Section 83 purposes, no purpose is served by making a Section 83(b) election for an NQSO that is subject to a substantial risk of forfeiture. An NQSO is only property for Section 83 purposes if it has a readily ascertainable fair market value at grant, determined in accordance with the Code and Treasury Regulations (which is extremely rare).

Finally, even if an NQSO is granted at-the-money, subsequent appreciation in the value of the underlying stock will cause the option to be in-the-money at the time of exercise. Unless the transferred stock is subject to a substantial risk of forfeiture (which is atypical), the option holder will be subject to tax on the option's spread or intrinsic value when exercised. This ability to choose the time of exercise and taxation (within the option's exercise window) helps grantees in their tax planning, but sometimes delaying exercise too long can lead to adverse consequences, as discussed in the section entitled "Deciding When to Exercise Stock Options" under Selected Tax Issues for Equity Grants below.

Comparing NQSOs and Restricted Stock

Both restricted stock and NQSOs allow for a deferral of taxable income beyond the grant year. The deferral period for restricted stock depends upon the date it vests (i.e., is no longer subject to vesting or a substantial risk of forfeiture), whereas the deferral period of an NQSO can be stretched out by the grantee until exercise. As a result, the economic advantage of restricted stock is generally offset by the lack of control over vesting, whereas the economic disadvantage of an NQSO is offset by having control over the timing of exercise. This is one reason many people prefer options over other forms of equity-linked compensation with fixed vesting or settlement dates.

Other Equity-Based Awards

Other forms of nonqualified equity-linked compensation include stock appreciation rights, restricted stock units, and various forms of performance-based compensation, usually payable as cash bonuses and taxable as ordinary income subject to withholding and employment taxes (e.g., cash-settled phantom stock plans).

Stock appreciation rights (SARs) are similar to stock options in that the employee benefits from the difference between the fair market value of the employer's stock on the exercise date and a hypothetical exercise price set by the employer. Unlike stock options, however, the grantee generally does not need to pay any exercise price out-ofpocket. In other words, a SAR is essentially a bonus settled either in cash, employer stock, or a combination of cash and stock on the exercise date (which may be elected by the grantee or designated in the grant award). The spread or intrinsic value is fully taxable to the employee as compensation subject to withholding and employment tax, and an equal amount is deductible by the employer. SARs do not implicate Section 83 unless they are stock settled, and even in that case its special timing rules are generally not relevant since the issued shares are usually not subject to a substantial risk of forfeiture.

Restricted stock units (RSUs) are an unfunded, unsecured contract right providing the employee with the right to receive one share of employer stock for each RSU (or an equivalent cash payment, or a combination of both) at some specified time in the future, typically after satisfaction of either time-based or performance-based vesting requirements. Like a SAR, RSU income is fully taxable as compensation at the time it is settled, subject to withholding and employment tax, and an equivalent amount is deductible by the employer. Unlike restricted stock, an RSU is simply an accounting entry and does not result in the transfer of employer stock unless it is stock settled. Thus, like SARS, Section 83 is not implicated until the issuance of shares (if applicable) and its special timing rules are generally not relevant since the issued shares are usually not subject to a substantial risk of forfeiture.

Profits interests are partnership equity interests (or membership equity interests in an LLC) that provide for a right to a future income stream from the entity's profits and/or a share of the proceeds upon a liquidity event, but which generally do not carry the same rights as the entity's capital interests. Profits interests are briefly discussed above in the section entitled "Observations on Theophilos" above, under Where It All Begins – Section 83 and in the section entitled "The Choice of Equity and Its Impact on Equity Grants" under Selected Tax Issues for Equity Grants below. For additional information, see Understanding Partnership and LLC Equity Compensation for a discussion of capital interests and profits interests granted by LLCs.

Selected Tax Issues for Equity Grants

The following sections discuss some discrete issues that arise for grants of equity-based compensation.

Which Are Better – ISOs or NQSOs?

The employee's tax benefit associated with qualifying QSOs (i.e., ISOs or ESPP options) is asymmetric from the employer's perspective. Although the employee's tax consequence is deferred until the underlying stock is sold, the employer is not permitted a deduction at any time for any QSO-related income reported by the employee. I.R.C. § 421(a)(2).

Depending on the respective effective tax rate of the employee and the employer, an ISO may not be more tax favorable than an NQSO when viewed from the combined perspective of employer and employee (commonly referred to as a global perspective). From a global perspective, an ISO may be viewed more favorably by a start-up or emerging company that anticipates incurring operating losses for an extended period (since the deduction is not needed to offset income). On the other hand, the high-profile compensation deductions reported by tech companies such as Facebook may swing the global perspective pendulum in the direction of NQSOs.

Regardless of the asymmetric tax benefit, an employee may prefer ISOs because there is no income tax consequence at the time of grant or exercise (although the spread or inherent value of the option may be subject to AMT upon exercise) and because any resulting gain upon the employee's later sale of the stock is taxed as capital gain (except in the case of a disqualifying disposition, as discussed earlier), potentially eligible for a lower tax rate. The capital gain is comprised of both the option's inherent value at the time of exercise and any appreciation in the stock's value thereafter. In addition, since no amount is taxable as wage compensation for a qualifying disposition of an ISO, neither the employer nor the employee will incur payroll taxes.

ISOs are not always the better options, however. Not surprisingly, various studies have determined that employees frequently exercise and dispose of their ISOs soon after vesting, before the holding period requirements are satisfied, which effectively eliminates the tax advantage of an ISO over an NQSO. Even those employees who otherwise desire to benefit from the post-exercise deferral period often are required to prematurely dispose of a portion of their shares because a lack of available funds forces them into a cashless exercise. Employees may also be required to sell or convert their ISO-acquired shares in the event of a corporate transaction that occurs prior to the end of the holding periods.

In some circumstances, the impact of the AMT at the time an ISO is exercised may significantly offset the economic benefit from the ISO's enhanced deferral period. As a result, affected employees may consider a disqualifying disposition so as to obtain a refund of previously paid AMT.

Other than avoiding compensation income that is subject to ordinary income tax rates and payroll taxes, the advantages of an ISO over an NQSO are limited to the enhanced tax deferral period (which may not be very long given the prevalence of cashless exercises or a forced sale), avoidance of income tax if shares are held until the employee's death (which may be eliminated in future tax reform proposals), and the ability to offset capital gain when shares are disposed of against capital losses or capital loss carryovers (which may be of limited utility to many employees). If future tax reform narrows the rate differential between ordinary income and capital gain rates, it would not be too surprising to see employers who previously granted ISOs encouraging their employees to make disqualifying dispositions. Such dispositions would allow the employer to obtain a tax deduction equal to the income reported by the employee without too much tax pain on the employee's part. In fact, employers would be expected to share a portion of their tax savings through bonuses intended to cover part or all of the tax incurred by those employees making disqualifying dispositions.

Deciding When to Exercise Stock Options

Following are considerations that you should address when advising ISO and NQSO stock option grantees on the tax implications of stock option exercise timing.

ISO exercise. Since the exercise price (also known as the grant price, option price, or strike price) of an ISO must not be less than the fair market value of the employer's stock on the grant date, there is generally no sound economic rationale for an employee to exercise the option too quickly (while recognizing the 10-year limit on exercise). Instead, a typical employee will hold an ISO until the option is in the money—that is, the price of the employer's stock is higher than the exercise price (generally referred to as the spread or the inherent value of the option). An employee may have the choice to exercise the option for cash (a cash exercise) or pay for all or part of the shares by immediately selling a portion of the transferred shares (a cashless exercise), if the plan or option award permits. Although a cashless exercise will result in the potentially less advantageous tax treatment of that portion of the ISO award due to the disqualifying disposition.

NQSO exercise. To avoid paying the exercise price and incurring tax on the intrinsic value of the option, many employees delay exercising their options until they feel less risk averse about their employer's stock. That delay, while psychologically understandable, may be penny wise but dollar foolish in some circumstances. For example, if an independent buyer offers to acquire the employer's stock, an employee who delayed exercising an NQSO will discover that his or her sale proceeds are taxable as compensation income without any portion obtaining capital gain treatment. The example below illustrates how an earlier exercise could be more tax advantageous.

Example (adverse consequences of delayed NQSO exercise). On June 1, 2012, ABC Corp. granted an NQSO to Juan, an ABC employee, allowing him to purchase 2,000 shares of ABC stock. The exercise price is $10 per share (the fair market value on the grant date) and the option vests in full on June 1, 2014. The fair market value of a share of ABC's stock on January 1, 2015 is $20. On May 15, 2017, Juan is notified that the stock of ABC is being acquired by Bigco Inc. effective June 1, 2017, for $50 per share. As of May 15, 2017, Juan had not exercised his option. The change-in-control provision of his option provides, in part, as follows:

"In the event a Change in Control appears likely to occur, the Company may, in its sole and absolute discretion, send written notice to the Participant at least ten days prior to the contemplated date of any Change in Control specifying (a) that the Option will become exercisable in full on the date of the Change in Control, (b) that any portion or all of the Option which thereby becomes exercisable and any portion or all of the Option which was already exercisable will immediately thereafter expire on the same date, and (c) that to prevent the lapse of the Option, the Participant must exercise the Option no later than such date."

As required by the change in control provision, Juan must exercise his NQSO no later than June 1, 2017. Based on Bigco's offer price, the spread is $80,000 (2,000 shares multiplied by $40 per share ($50 offer price less $10 option price). The entire spread is taxed as compensation income, subject to withholding and employment tax.

If Juan had exercised his NQSO on January 1, 2015, he would have paid $20,000 for the shares and incurred tax on a spread of $20,000 (2,000 shares multiplied by $10 per share ($20 value less $10 option price). His adjusted basis in the transferred shares would have been $40,000. When Juan then sells the underlying shares to Bigco on June 1, 2017, the full amount of post-exercise appreciation ($60,000), less his adjusted basis ($40,000), is subject to tax as long-term capital gain ($20,000). Juan's delay in exercising the option prevented him from converting $60,000 of compensation income into capital gain, which, unlike compensation, allows for recovery of basis.

Deciding Whether to Make a Section 83(b) Election

A Section 83(b) election is often made upon receiving property that is subject to a substantial risk of forfeiture (e.g., upon receipt of restricted shares that are forfeitable during a vesting period) to recognize taxable income in the year of grant, rather than a later year when the property vests. The following example illustrates the potential beneficial effect of making the election.

Example (Section 83(b) election). Jill, who is employed by CBA Co., receives 2,000 shares of CBA stock that vest in full on the fourth anniversary of the grant date, as long as Jill remains continuously employed by CBA through that date. Jill is not required to pay anything for the shares, which have a fair market value of $10 per share on the grant date. As of the vesting date, CBA shares have increased to a fair market value of $50 per share. Two years after the vesting date, CBA is acquired by Bigco Inc. and Jill disposes of all of her shares at that time for $100 per share.

- **No Section 83(b) election.** If Jill does not make a timely Section 83(b) election, the taxable event will be deferred until the shares are no longer subject to a substantial risk of forfeiture (i.e., the vesting date). Thus, on the fourth anniversary of the grant date, Jill would be subject to tax on $100,000 of compensation income (2,000 shares times $50 per share fair market value on the vesting date), which is subject to withholding and employment tax.

Then, when Jill sells her CBA shares two years after vesting her proceeds will be $200,000. Her basis in the CBA shares is $100,000, which is the amount of compensation income she recognized when the shares vested. See 26 C.F.R. § 1.83-4(b). Therefore, Jill will report a $100,000 long-term capital gain upon disposing of the shares (and previously reported $100,000 of ordinary income upon vesting).

- **Section 83(b) election.** If Jill does make a timely Section 83(b) election, she will be subject to tax on $20,000 of compensation income at the time the restricted shares are granted (2,000 shares times $10 per share fair market value on the grant date), which is subject to withholding and employment tax. When her shares vest on the fourth anniversary of the grant date, there is no additional tax consequence. When she disposes of the shares two years after vesting, she will report a $180,000 long-term capital gain (gross proceeds of $200,000, less basis of $20,000).

The effect of the Section 83(b) election in the example above is to transform $80,000 of ordinary income into longterm capital gain. Another consequence of the Section 83(b) election is to start Jill's holding period for the shares as of the grant date. The latter benefit may be particularly important should an unexpected disposition of the shares occur at a time less than one year after the scheduled vesting date, such as in the case of an accelerated vesting event involving a forced sale.

A Section 83(b) Election Should Be Made Even When Paying Fair Market Value

In Alves v. Comm'r, 79 T.C. 864 (1982), an employee purchased 40,000 shares of his employer's stock paying an amount equal to the fair market value of the stock on the transfer date. Although the shares were subject to a substantial risk of forfeiture, the taxpayer did not make a Section 83(b) election. After the restrictions lapsed, the taxpayer sold shares reporting the difference between the sale proceeds and the amount previously paid as capital gain. On audit, the IRS reclassified that difference as compensation income.

Both the Tax Court and the Ninth Circuit Court of Appeals upheld the IRS's audit determination. The fact that the shares did not have an intrinsic value when granted was irrelevant to the operation of Section 83, as made clear by the Ninth Circuit:

Alves last contends that since every taxpayer who pays full fair market value for restricted stock would, if well informed, choose the section 83(b) election to hedge against any appreciation, applying section 83(a) to the unfortunate taxpayer who made no election is simply a trap for the unwary. The tax laws often make an affirmative election necessary. Section 83(b) is but one example of a provision requiring taxpayers to act or suffer less attractive tax consequences. A taxpayer wishing to avoid treatment of appreciation as ordinary income must make an affirmative election under 83(b) in the year the stock was acquired.

Alves, 734 F.2d at 483.

Assuming restricted stock appreciates in value, a timely Section 83(b) election will minimize compensation income and maximize capital gain.

Risks of Section 83(b) Elections

Since a Section 83(b) election generally may not be revoked, the employee is essentially placing a bet on the future appreciation of the shares. See 26 C.F.R. § 1.83-2(f). If the employee from the example above makes a Section 83(b) election, she will recognize $20,000 of ordinary income in the election year (equal to the fair market value of the stock on the grant date). Now consider the situation if the business fails and the stockholders are wiped out. Then, she has, potentially, a $20,000 capital loss. Disregarding the tax rate differential between ordinary income and capital gain, she may recover some of her grant year tax liability if she has capital gains that can be offset by the capital loss. However, under current tax rules, she may be limited to recognizing no more than $3,000 of capital loss each year, which means that it could take almost seven years to utilize the full capital loss.

Even worse, by making a Section 83(b) election, the grantee assumes the risk that the vesting conditions will not ultimately be met and the property is never transferred to the grantee. In that case, any income liability incurred at the time of grant is completely foregone, as the grantee is not eligible for a refund or credit. 26 C.F.R. § 1.83-2(f).

Considerations for Making a Section 83(b) Election

The larger question is whether a Section 83(b) election should be made, and the answer to that question often turns on whether the underlying stock is publicly traded, how bullish the employee is on the stock, and whether there is a chance the employee may separate from service prior to vesting.

If the employer's stock price is expected to rise, a Section 83(b) election would appear to be advisable in order to convert as much compensation (ordinary) income into capital gain as possible. However, a more sophisticated approach may be to invest available cash in additional shares of the employer's stock rather than use it to pay tax on intrinsic value in the grant year. See David I. Walker, "The Non-Option: Understanding the Dearth of Discounted Employee Stock Options," 89 B.U. L. Rev. 1506, 1556–57 (2009).

Given their lack of access to additional shares, employees of private corporations, on the other hand, would be expected to make Section 83(b) elections, but only if they are confident that there is a low risk of forfeiting the shares prior to vesting and the future return on investment will exceed any out-of-pocket cost. Id.

Discounted Options and Section 409A

As previously discussed, at-the-money NQSOs generally fall outside of Code Section 83(a) because they usually lack a readily ascertainable fair market value at the time granted. Whether an in-the-money option (also known as a discounted option) falls outside of Section 83(a) is more complicated, but is largely a moot point since the enactment of I.R.C. § 409A and its implementing regulations (Section 409A).

In the past, the IRS aggressively pursued the classification of discounted options as property for Section 83 purposes. This was particularly true when an option was so deeply discounted that it was virtually certain to be exercised. E.g., Rev. Rul. 82-150, 1982-2 C.B. 110 ("By obtaining the right to purchase for 30,000x dollars stock worth 100,000x dollars, A has assumed the risks of an investor in equity"). The courts have not always shared that view, however. See, e.g., Victorson v. C.I.R., T.C. Memo. 1962-231 (1962), aff'd 326 F.2d 264 (2d Cir. 1964). In Victorson, options with a strike price of one mill ($.001) and a fair market value of $1.125 on the grant date were treated as lacking a readily ascertainable value on grant and consequently were not taxable until exercise. Id. at *29—*30 ("But these were options to purchase, albeit for a small amount, and in the circumstances we think it would not be proper to say that Graham Ross or Victorson realized any income with respect to the option stock until the date they in fact made the investment required under the options.")

Today, the application of Section 83 to a discounted option has largely been rendered irrelevant by Section 409A. The significant adverse tax consequences associated with an NQSO that fails to either qualify as an exempt stock right or comply with Section 409A's documentation and operational standards present a substantial barrier to any continuing interest in discounted options, outside of special circumstances. Those consequences include the triggering of the employee's tax obligation at the time the option vests, including applicable withholding and employment taxes, and the imposition of a 20% surtax. For background on Section 409A and its application to stock options, see Understanding Nonqualified Deferred Compensation Arrangements and Internal Revenue Code Section 409A and Stock Option, SAR, and RSU Grant Drafting Checklist (Section 409A Compliance), respectively.

Options Eligible for the Section 409A Stock Rights Exemption

Under the Section 409A stock rights exemption, a stock option will not provide for a deferral of compensation (and therefore will not be subject to Section 409A) if all of the following requirements are satisfied:

- The exercise price is never less than the fair market value of the underlying stock on the date the option is granted.
- The number of shares subject to the option is fixed on the original date of grant of the option.
- The transfer or exercise of the option is subject to taxation under Section 83 and § 1.83-7 (i.e., the stock option does not have a readily ascertainable fair market value on the grant date).
- The option does not include any features for the deferral of compensation other than the deferral of recognition of income until the later of:
- The exercise or other taxable disposition of the option under § 1.83-7 –or–
- The time the stock acquired pursuant to the exercise of the option first becomes substantially vested (as defined in § 1.83-3(b)) 26 C.F.R. § 1.409A-1(b)(5)(i)(A).

To avoid the application of Section 409A, an NQSO must not be granted at a discount off the grant date fair market value. The award should demonstrate this intent by expressly stating that the exercise price is not less than the fair market value of the underlying stock on the grant date. The Section 409A regulations provide guidance for establishing the fair market value of employer stock, both in the case of publicly traded stock and stock that is not traded on an established securities market. 26 C.F.R. § 1.409A-1(b)(5)(iv).

When valuing nonpublicly traded stock, the company must use a reasonable application of a reasonable valuation method. Factors that must be considered include the value of the tangible and intangible assets of the corporation, the present value of the future cash flows of the corporation, and the market value of stock or equity interests in similar corporations, among other things. 26 C.F.R. § 1.409A-1(b)(5)(iv)(B). The valuation regulations also provide for a presumption of reasonability if the valuation is determined by an independent appraisal meeting the requirements of I.R.C. § 401(a)(28)(C) as of a date that is no more than 12 months before the grant date (so long as no material events have occurred in the interim). 26 C.F.R. § 1.409A-1(b)(5)(iv)(B)(2)(i). Other presumptively reasonable valuation methods can apply in certain circumstances. See 26 C.F.R. § 1.409A-1(b)(5)(iv)(B)(2)(ii), (iii).

It is best practice to retain a qualified appraiser (or rely on an alternative applicable safe harbor method) to obtain the grant date fair market value of the employer's stock. Doing so can protect against an assertion on audit that Section 409A applies to NQSOs intended to qualify for the stock rights exemption. It can be a costly mistake to have an NQSO valued by anyone other than a qualified appraiser.

If, in a desire to save the cost of a third-party appraisal, someone who lacks the requisite qualifications prepares a valuation report that does not meet the regulatory standard and NQSOs are granted at a discount (based on a reasonable valuation), the stock rights exemption will fail to apply retroactively to the grant date, triggering the 20% additional tax under Section 409A and, potentially, an interest penalty.

Primarily for this reason, discounted options are rarely observed today. Note that no similar concern attaches to the issuance of restricted stock to an employee for no consideration, even though the economic effect, as discussed below, is analogous to deeply discounted NQSOs. The reason why there is no similar concern is because Section 409A does not apply to restricted stock grants covered by Section 83. 26 C.F.R. § 1.409A-1(b)(6)(i).

From a purely economic viewpoint, there is virtually no difference between restricted stock and a deeply discounted NQSO. Restricted stock can be viewed as zero-cost stock since it is usually granted without requiring the employee to pay any consideration for the stock. A deeply discounted NQSO falls just to the right of restricted stock on the pricing continuum that ranges from zero-cost restricted stock on the left to out-of-the-money NQSOs on the right (i.e., where the exercise price of the option exceeds the underlying stock price on the exercise date).

How to Grant Section 409A-Compliant Discounted NQSOs

Although it is no longer common, special circumstances may demand the grant of a discounted NQSO. For example, a highly valued employee may inadvertently allow a prior NQSO to lapse prior to an offer for the employer's stock by a third party. To allow the employee to benefit from the transaction, she may be granted a new NQSO at her original option price, which would be less than the current fair market value of the employer's stock. Although the employee would not be able to obtain long-term capital gain treatment on disposition of her shares, she will still benefit financially from the transaction. In fact, she may be no worse off financially than other employees holding unexercised NQSOs. As previously discussed, it is common for an employee to delay exercising an NQSO until there is substantial certainty that the return on investment will exceed the cash outlay and related tax cost. Often, that delay prevents the employee from meeting the long-term capital gain holding period. Such a delay can also minimize the portion of the total proceeds allocated to capital gain even when the holding period requirement is satisfied.

The only way to grant a discounted NQSO without incurring Section 409A's adverse tax consequences for the employee is to remove the employee's discretion as to when the option may be exercised, by limiting exercise to one of the Section 409A permitted distribution events described in I.R.C. § 409A(a)(2)(A). That is, the financial trade-off for the financial certainty provided by a discounted option is to restrict the employee's power to unilaterally select the tax year in which she will recognize the option's intrinsic value. In contrast to restricted stock, a Section 409A-compliant discounted NQSO can defer tax beyond its vesting date, but only if the exercise trigger is outside the employee's control.

For stock options that are exercisable only upon the occurrence of a liquidity event, fixing the date of exercise at the time of the change in control will usually not present a serious problem for discounted NQSOs, although care must be taken to make sure that exercise may only be triggered by a change in control that falls within one of the definitions under 26 C.F.R. § 1.409A-3(i)(5). Another alternative for discounted NQSOs is to designate a specific future year in which the option must be exercised. For increased flexibility, these permissible payment events can be combined so as to provide for exercise, for example, upon the earlier to occur of a fixed exercise date or a qualifying liquidity event. Note that one potential advantage to a Section 409A-compliant discounted NQSO over a grant of restricted stock is that the fixed exercise date (and, therefore, the tax event) can be set beyond the vesting date, while nevertheless including the possibility for acceleration in the event of a liquidity event.

The Choice of Entity and Its Impact on Equity Grants

The federal income tax classification of the entity in which an employee is offered an equity interest controls the tax consequences to the employee and the employer. Importantly, the employee's tax advisor must make his or her client aware of the tax issues that can arise not only upon the grant of an equity interest, but also any tax consequences that may arise after the employee becomes an equity owner. The following example illustrates this point.

Example (LIFO reserve). PDQ Corp., which is subject to tax as an S corporation, is an automobile dealership that many years ago elected under I.R.C. § 472 to use the last-in, first-out (LIFO) inventory method. Briefly, in an inflationary economy, the LIFO inventory method reduces net income reported for federal tax purposes. The difference between net income reported using LIFO and the net income that would have been reported using the first-in, first-out inventory method represents deferred taxable income and is tracked in the LIFO reserve. At some time in the future, the LIFO reserve will collapse and tax on the deferred income will come due. Until that time, the tax deferral can be thought of as an interest-free loan from the government to PDQ's existing shareholders.

PDQ grants stock to Jane, a long-time employee. In addition to the tax issues arising upon grant of the stock, Jane should understand that, if the LIFO reserve is terminated for any reason subsequent to her becoming a shareholder, she will be subject to tax on her proportionate share of the triggered tax, regardless of whether ABC distributes cash sufficient to pay that liability. Jane's attorney or accountant should explain this and other longerterm tax consequences to her prior to the stock grant, so that she can make a fully informed decision whether to accept it. Upon being advised of all of the tax consequences of stock ownership, Jane may instead ask PDQ for a synthetic form of equity, such as phantom stock (which is most commonly cash-settled). Although cash-settled phantom stock cannot qualify for long-term capital gain treatment, it avoids adverse tax consequences of stock ownership, such as an untimely trigger of a LIFO reserve.

Example (LLC profits interest). XYZ LLC is a limited liability company that is classified as a partnership for tax purposes (hereafter, referred to as an LLC). On March 1, 2017, XYZ granted a profits interest to Joe, a long-time employee. As of that date, Joe became a member of XYZ and consequently ceased being classified as an employee, in accordance with IRS guidance. See Rev. Rul. 69-184, 1969-1 C.B. 256; T.D. 9766, 2016-1 C.B. 855.

This means that XYZ will not continue to withhold income and employment taxes from Joe's wages, and she will not receive a Form W-2 for compensation earned subsequent to the grant date, even if the profits interest does not vest until a later tax year. See Rev. Proc 2001-43, 2001-2 C.B. 191 (clarifying that if the profits interest is substantially nonvested at the time of grant, the service provider will be treated as owner of the interest from the grant date). Instead, Joe is treated for tax purposes as self-employed, thereby requiring him to make quarterly estimated tax payments and pay the full employment taxes on his distributive share of LLC income and any guaranteed payments he may receive (subject to an above-the-line deduction for such taxes when he files his income tax return). Perhaps more importantly, Joe will no longer be allowed to participate in some of XYZ's employee benefit plans that require employee status for participation, including its cafeteria plan, or participate tax-free in health or transportation fringe benefit plans, among other things. Joe may prefer remaining an employee for tax purposes over becoming a member of the LLC, in which case, a synthetic form of equity can closely align his long-term financial goals with the financial interests of the partners.

See Understanding Partnership and LLC Equity Compensation for a discussion of capital interests and profits interests granted by LLCs.

There are many other prospective tax issues that should be addressed at the time an employee is considering whether to accept an employer's offer of equity-linked compensation. What is clear is that to narrow a focus on the immediate tax issues associated with an equity grant may result in an unbalanced decision to accept or reject the offer.