



Equity Based Compensation

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Presenters



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Agenda

- Equity based compensation
- Qualified small business stock requirements
- Income tax law update(s)
- Questions

This webinar does not qualify for CPE



IRC Section 83(a)

- Transfer of property in exchange for the performance of services
- Excess of the fair market value of property, less the amount paid (if any), is included in gross income at the first time:
 - Interests are transferable (no conditions requiring its return)
 - No Substantial Risk of Forfeiture
- Substantial Risk of Forfeiture Defined
 - Rights in property are conditioned upon future performance (or refraining from performance) of substantial services by any person



Basics of Equity Vehicles

Types of Awards – Long-Term Incentive Awards & Equity Based Compensation Awards:

- Restricted Stock Grants
- Stock Option Grants
 - Incentive Stock Options (ISOs)
 - Nonqualified Stock Options (NQSOs)



Restricted Stock Awards (RSAs)

- The transfer of stock on grant date
- limitations on either
 - Transferability, or
 - A subject to a substantial risk of forfeiture (i.e., future services required to vest)
- Grantee is owner of stock
 - Voting rights
 - Dividend rights



Tax Effects of Restricted Stock Awards

- Tax Effect to Grantee
 - Taxed when shares vest (i.e., no longer subject to restrictions on transferability or substantial risk of forfeiture)
 - Subject to ordinary income rates
 - Taxable income = FMV on vest date - Amount Paid
 - Tax basis = Taxable Income + Amount Paid
 - Capital Gain/Loss upon subsequent sale
 - Eligible for an 83(b) election



83(b) Election

- 83(b) election accelerates tax event
- Generally, stock appreciation after 83(b) election taxed at long term capital gains rates
- Forfeiture of shares after 83(b) election does not result in ordinary deduction or capital loss
 - (except for amounts paid, if any)
- Election must be made within 30 days of:
 - Grant – RSA
 - Exercise – Options
 - Not applicable to RSUs



Tax Effects of Restricted Stock Awards

- Tax Effect to Employer
 - Deduction equal to amount **includible** in as ordinary income to Grantee
 - Amount must be included on W-2 or 1099-MISC
 - Withholding and reporting at time of vesting
 - Generally, timing of deduction is at employee income recognition



Restricted Stock Units (RSUs)

- Employee granted notional units representing shares of Employer stock
 - No transfer of shares on grant date
- RSUs may be settled in
 - Shares
 - Cash
 - Other property



Tax Effects of Restricted Stock Units

- Tax Effect to Grantee
 - Taxed when settled
 - Shares delivered
 - Cash paid
 - Subject to ordinary income rates
 - Taxable income = FMV on vest date – Amount Paid
 - Tax basis = taxable Income + Amount Paid
 - Capital gain/loss upon subsequent sale (if stock settled)
 - Not Eligible for 83(b)



Tax Effects of Restricted Stock Units

- Tax Effect to Employer
 - Deduction equal to amount **includible** in as ordinary income to Grantee
 - amount must be included on W-2 or 1099-MISC
 - Withholding and reporting at time of vesting
 - Generally, timing of deduction is at employee income recognition



Stock Options

- The right to purchase stock at a set price over a specified period of time
 - Incentive Stock Options (ISOs)
 - Nonqualified Stock Options (NQs)
- Section 83 Treatment
 - If the value of the option is not readily ascertainable on date of grant, then taxable on exercise Reg. Sec. 1.83-7



Tax Effects - NQs

- No statutory limitations
- May include non-employees
- Taxed at date of exercise
- Employee
 - Ordinary income tax at exercise
 - Tax basis = FMV on exercise date
 - Capital Gain/loss upon sale subsequent sale
- Employer
 - Deduction equal to amount includible
 - Withholding and reporting at time of exercise (employees)



ISO Requirements

- Federal Tax Requirements
 - Specify aggregate number of shares
 - Identify eligible Employees or class of Employees
 - Plan term does not exceed ten years
 - Shareholder approval within 12 months
 - Limited to \$100,000 of stock that first becomes exercisable in any calendar year



ISO Requirements

- Option Requirements
 - Granted by Employer, parent or subsidiary corporation
 - Option must be for purchase of stock of Employer, parent or subsidiary
 - Option granted only to Employees
 - Exercised while an Employee, or within three months of termination or death, or one year of disability
 - Ten-year term
 - five-year term for 10% or more shareholders
 - Exercise price of at least FMV on grant date
 - 110% of FMV for 10% or more shareholders



ISO Requirements - Continued

- Holding period requirements
 - Employee must not dispose of stock for at least 2 years from grant date
 - Stock must be held for at least 1 year from exercise date



Tax Effects of ISOs - Employee

- Alternative Minimum Taxable Income (AMTI) at exercise
 - Equal to spread on exercise date
- *May* result in Alternative Minimum Tax
 - Credit carryforward available
- If holding period is met
 - Long-Term Capital gain on sale
 - Equal to sales price less option price
- Subject to disqualifying disposition



Tax Effects of ISOs - Employer

- No corporate tax deduction unless disqualifying disposition
- Withholding not permitted
- Form 3921 reporting requirement on exercise of ISO



ISO Disqualifying Disposition

- Holding period not met
- Ordinary tax on lesser of
 - Spread on exercise
 - Spread on sale date
- No withholding requirement



Equity Compensation – Tax Summary

Employee	NQSO	ISO	Restricted Stock Unit	Restricted Stock Award
Grant Date	No Tax Impact	No Tax Impact	No Tax Impact	No Tax Impact *
Vesting Date	No Tax Impact	No Tax Impact	Ordinary Income	Ordinary Income *
Exercise Date	Ordinary Income on Spread	No Tax Impact **	N/A	N/A
Sale Date	Capital Gain on Appreciation From Exercise	Capital Gain	Capital Gain on Appreciation From Lapse Restrictions	Capital Gain on Appreciation From Lapse Restrictions
Employer				
Grant Date	No Tax Deduction	No Tax Deduction	No Tax Deduction	No Tax Deduction
Vesting Date	No Tax Deduction	No Tax Deduction	Deduction Equal to Ordinary Income	Deduction Equal to Ordinary Income *
Exercise Date	Deduction Equal to Spread	No Tax Deduction	N/A	N/A
Sale Date	No Tax Deduction	No Tax Deduction	No Tax Deduction	No Tax Deduction

* Assumes the executive does not make a Section 83(b) election

** AMT may be applicable



Qualified Small Business Stock (“QSBS” / “§1202”)

Benefit: Federal income tax exclusion of gain upon sale: Up to 10x basis or \$10mil.

Requirements:

- Domestic C Corporation
- Original Issuance Stock issued after Aug 10, 1993
- Adjusted basis of corporation’s assets under \$50mil
- Active conduct of a qualified trade or business
- No stock redemptions greater than 5% of Fair Market Value during qualifying period
- Held for minimum of five years



QSBS Gain Exclusion Amounts & Dates

<u>Stock Issuance Date</u>		§1202 Exclusion %	§1202 Effective Tax Rate	Tax Rate W.O. §1202	§1202 Fed Rate Savings
<u>Beginning</u>	<u>Ending</u>				
8/11/1993	2/18/2009	50%	15.9%	23.8%	7.9%
2/19/2009	9/27/2010	75%	7.95%	23.8%	15.85%
9/28/2010	-	100%	0%	23.8%	23.8%

- *50% & 75% QSBS eligible gains not excluded from income is subject to 28% capital gains rate(s) plus Net Investment Income Tax (NIIT) of 3.8%.*
- *50% & 75% exclusions - Alternative Minimum tax preference is 7% of the excluded gain, not factored into effective rates.*



Qualified Small Business Stock (“QSBS” / “§1202”)

Example: No QSBS Tax Planning:

Jane sells QSBS stock in 2020 for \$10,000,000 with an \$800,000 tax basis. She excludes \$9.2 million of A Corp. Section 1202 gain. In 2021, Jane sells another block of stock with \$0 tax basis for \$10 million. Jane has a gain of \$9.2 million but can only exclude \$800,000 of gain because she excluded \$9.2 million of her \$10 million cap exclusion in 2020. In this example, by first disposing of the higher basis stock, Jane is only able to exclude \$10 million of her total \$19,200,000 gains.



Qualified Small Business Stock (“QSBS” / “§1202”)

Example: Good QSBS tax planning

Jane sells QSBS stock in 2020 for \$10,000,000 with a \$0 tax basis. She excludes \$10 million of A Corp. Section 1202 gain in 2020. She sells a second block of shares of A Corp. QSBS in 2021 for \$10,000,000 with an aggregate tax basis of \$800,000. She will be entitled to a Section 1202 gain exclusion of \$8,000,000 (10 X \$800,000 basis) in 2021, as she will have used her entire \$10 Million Cap for such issuer in 2020. The balance of her gain of \$1,200,000 will be taxed at the 20% long-term capital gains rate. Thus, by combining the two limitations over two tax years, Jane is able to exclude \$18,000,000 of her total \$19,200,000 gains.



Qualified Small Business Stock (“QSBS” / “§1202”)

Caveats:

- *Must be a stock sale – Buyers and sellers are at odds re: stock vs. asset sale/purchases. Buyers want assets, sellers want stock.*
- *Build Back Better removes 100% & 75% exclusions – see next slides.*
- *§1045 Rollover functions similarly to a §1031 exchange in deferring taxable gains. Must hold QSBS qualified stock for 6 months and rollover to qualifying new Corp within a 45 day period.*



Build Back Better Bill - Income Tax Implications

- *Disclaimer – not all inclusive & based on limited information*
- Removes QSBS 100% exclusion and brings limitation back to 50% (taxpayers with greater than \$400k AGI). – Retroactive to sales after 9/13/2021
- Apply 3.8% Net Investment Income Tax (NIIT) to all non-passive business income over \$400k.
- 5% tax rate increase on Adjusted Gross Income (AGI) in excess of \$10mil.
 - Additional 3% (on top of 5%) on AGI above \$25mil



Build Back Better Bill - Income Tax Implications

- Limit IRA's when balance reaches \$10mil and accelerate Required Minimum Distributions
- 1% excise tax on stock buybacks
- \$80 billion dollars of additional IRS enforcement funds – more audits with less experienced agents.
- Wash sale rules expanded to include Cryptocurrency, foreign currency & commodities.





Questions?

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Thank you!

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