Employee Stock Options: Tackling Complex Tax, Accounting and Valuation Challenges
Navigating IRC Section 409A, FASB Requirements, and the AICPA's Practice Guide to the Valuation of Options

TUESDAY, MARCH 17, 2015, 1:00-2:50 pm Eastern

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Employee Stock Options: Tackling Complex Tax, Accounting and Valuation Challenges

Mar. 17, 2015

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OVERVIEW OF AUTHORITATIVE GUIDANCE

Jeffrey E. Mead, CPA
Audit Partner
Basic terminology

Two Broad Categories of Options

Incentive stock options (ISO) – also referred to as "statutory" or "qualified" options – for senior executives only. Potential favorable tax treatment – must satisfy statutory (law) provisions

Non-qualified stock options (NSO) – for non-executive employees, and outside directors, consultants, etc. Potentially different tax results

Other Key terms

Grant date - date contract is awarded.

Vesting – period of time award vests to employee. Usually 3-4 years

Expiration date – date award expires. Commonly 10 years.

Exercise price – price per share that employee must pay to exercise option. Also referred to as the "strike price"
Basic terminology

Other Key terms

"In the money" options - exercise price at DATE OF GRANT below fair value of the underlying equity instrument

- Significant AMT tax exposure to recipient

"Out of the money" options – exercise price at DATE OF GRANT at or above fair value of the underlying equity instrument
Basic "rules" impacting equity compensation

Legal / Tax

IRC 409A – Non-qualified Deferred Compensation which is 'taxable' even though recipient receives no cash (Options, ESPPs, warrants)

IRC 83 - Property Transferred in Connection with Performance of Services
Common election to "lock in" capital gain on appreciation (NSO')

IRC 162 – Certain Excessive Employee Remuneration
Ex: Golden Parachute

Financial Reporting

ASC Topic 718 : Compensation – Stock Compensation
Why stock options?

- Innovative compensation plan when a Company has cash flow limitations
  - Early stage, pre-revenue companies – very common, or
- Innovative compensation plan to “link” Company value growth to compensation
- More of a US phenomena than Europe
- Prior to June 15, 2005, US GAAP did NOT require Companies to measure compensation expense – this all changed with ASC 718 (FASB 123 and 123R)
“Section 409A generally provides that unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are CURRENTLY INCLUDIBLE IN GROSS INCOME to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.”
IRC 409A

Substantial risk of forfeiture
Generally exists if employee’s right to the deferred compensation (difference between strike price and FMV) or transferred property (FMW of restricted stock over basis) is contingent on the performance of substantial services IN THE FUTURE, or the occurrence or nonoccurrence of a given event.
Deferred Compensation Plans

“...any plan that provides for the deferral of compensation, with specified exceptions such as qualified retirement plans, tax-deferred annuities, simplified employee pensions, SIMPLEs and section 501(c)(18) trusts. In addition, section 409A does not apply to certain welfare benefit plans, including bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans ¹.”

¹ Clarified in IRC Notice 2005-1
Options – In particular

IRC 409A does **NOT** apply to options/SARs that are granted at fair market value - "out of the money"

Fair Market Value ("FMV") is defined as “the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.” - United States v. Cartwright

- This drives "409A valuation" services
- Need to be sure options granted (ISO’s) are out of the money
Options - Statutory – Favorable tax treatment

Statutory Options: Incentive Stock Options (ISOs) ; Most common for US employees

• Granted at or above FMV (< Excludes them from §409A)*
• Not subject to tax on grant
• Not subject to tax upon exercise (subject to AMT however);
• Taxable upon sale as Capital Gains/losses if certain holding requirements met, taxable as ordinary income if holding periods not met (Disqualifying Dispositions)

*if not granted at or above FMV, they are considered non-statutory stock options
ISO holding period

Disqualifying Dispositions (sales that are taxable as ordinary income) occur when the ISO is sold within:

- 1 year of exercise
- 2 years of grant

Note, generally with ISOs the effective tax rate is higher, however with DD’s the allowable tax deduction may result in a lower effective tax rate.
Options – Non-Statutory – lacks favorable tax treatment

Non-Statutory Stock Options (Non-qualified Stock Options or NQSOs): Issued to both US and non-US employees, directors, consultants. Could also be warrants to non-employee personnel

• Required to be granted at or above FMV.
  • Otherwise significant §409A issues
  • 3rd party valuation needed to protect against valuation risk

• Taxable upon exercise, difference between FMV and grant price – taxed as ordinary income, capital gain/loss upon sale (difference between sale price and FMV at date of exercise)

• Or taxable when employee makes a “section 83b) election” and includes them in income

• May create a deferred tax asset external financial reporting
Options – Non-Statutory – lacks favorable tax treatment

• Grant of option is NOT taxable
• Tax incurred when option exercised
  • Ordinary rates
  • Amount between exercise price and fair value of the stock
• Tax incurred when shares sold – one year or less, ordinary income
• Subject to payroll taxes (FICA, FUTA)
Noncompensatory plans

- Employee share purchase plan (ESPP) NOT compensation for financial reporting and NOT taxable if:
  - Granted at or above FMV
- Considered "noncompensatory plans" for US GAAP
- Must satisfy certain criteria:
  - Plan’s term no more favorable compared to others: or,
  - Stock is not offered at a discount (5% or less meets criteria)
  - All full time employees can participate
  - No option features in terms of price, enrollment, etc.
Related Code Sections

§83(b) – Specifically allows for the current inclusion of FMV of granted equity as of the date of the election (usually grant date). You have 30-days from the date of receipt of the [stock] to make this election!!

**Good**: taxable at low value, locks in basis and starts capital gains clock

**Bad**: if forfeited, you cannot deduct the amount claimed as a stock loss (note if ‘vested’ you can deduct that portion of basis)
Related Code Sections

§162(m) – "Excessive Remuneration"

Limitation on the tax deduction of compensation to certain employees of $1 million per year. The rule applies to the compensation of the executive ("covered") officers named in the proxy (except for the CFO unless s/he is among the top three highest paid), who are employed as of the last day of the taxable year.

Does note apply to “qualified performance-based compensation”, evidenced by attaining goals established in a written plan, approved by the compensation committee/outside directors and shareholder vote.
Aren’t Options Performance-based?

Stock options and SARs are performance-based if the requirements for outside director and shareholder approval are met (see previous).

Restricted stock cannot qualify as performance-based compensation unless the grant or vesting is contingent upon the achievement of performance goals.

If not performance based, unplanned inclusion due to below FMV option grants will be considered in the $1M limit.
ASC Topic 718: Compensation – Stock Compensation

Share based payment transactions must be recognized in the as compensation expense at the date of grant and forward

A compensation charge based on Fair Value at date of grant is recognized over the vesting period based on the number of awards that vest.

Equity-classified awards are ‘fixed’ as of the grant date unless the award(s) are modified. Liability-classified awards are re-valued at the end of each reporting period until settled.
ASC Topic 718: Compensation – Stock Compensation

This topic provided general guidance with US GAAP related to share-based payment arrangements. Generally, in all transactions (excluding ESOPs) in which an entity acquires goods or services by issuing shares, share options, warrants, or other equity investments are subject to ASC Topic 718. The accounting will either be "equity-based," or "liability-based."
ASC Topic 718: Compensation – Stock Compensation

Fair Value ("FV") is the amount at which the asset could be bought or sold in a current transaction between willing parties, or transferred to an equivalent party, other than in a liquidation sale.
Subtleties: Tax vs. Accounting

Fair value vs. fair market value

Fair market value: The search for the price at which the property would change hands between a willing buyer and a willing seller under no compulsion to buy.

Fair Value: The search for the price to sell an asset or paid to transfer a liability in an orderly transaction between market participants.
Subtleties: Tax vs. Accounting

Fair value vs. fair market value

US GAAP: fair value used. FASB wanted to distance itself from "non-conservative" discounts stemming out of certain tax court rulings.

IRS: fair market value used. The tax court additionally upholds control premiums/minority discounts, blockage discounts, key-person discounts, contingent liability discounts, and portfolio discounts – to name a few.
Summary

The preceding are the general rules to impacting financial and tax considerations in the granting of equity. Naturally there are rules governing the determination of the type of equity and the exceptions....

But now what? Further complicating the equity structure, Term Sheets.
Back to the Rules…. The Operative Provisions

Legal / Tax

IRC 409A – Non-qualified Deferred Compensation (Effective Date: 2005); ex: Options, ESPPs, warrants

IRC 83 - Property Transferred in Connection with Performance of Services (Effective Date: 1969); ex: Restricted stock

IRC 162(m) – Certain Excessive Employee Remuneration
Ex: Golden Parachute

Financial

ASC 718 – Stock Based Compensation (Formerly FAS 123R): Revised 2004
A quick note…. 

Determination as to whether a plan is in compliance with the rules governing it, plan documentation, reporting, etc., is beyond the scope of this discussion. The presumption is that the compensation plan is approved, written, and in accordance with any applicable initialization and maintenance requirements.
§409A Reporting Requirements

Options are excluded from §409A when issued at FMV. IRS spells out the following detailed guidance with regard to supporting what FMV is:

Reg. §IRC 409A-1(b)(5)(iv)(b): “…FMV… means a value determined by the reasonable application of a reasonable valuation method....”

Translation: If you are not considered an expert or validly experienced, hire an outside valuation firm to perform the analysis. Guesstimates do not work however educated in their approach.

Evaluate risk - saving expense of 3rd party valuation vs. can you support FMV.

- Could possibly be a FIN 48 disclosure item
§409A

Valuation reports must include overviews of the Company, industry, economic environment, assumptions, and descriptions of the method(s) employed in determining the value of the underlying equity.

The IRS has quasi-defaulted to relying reports based on a low-level hierarchical AICPA Practice Guide for the valuation approach “Valuation of Privately Held Equity Securities Issued As Compensation – Accounting and Valuation Guide - Issued in 2013.

Best to use 3rd party valuations
Restricted Stock

Restricted stock is awarded to top performing employees, in which they ‘vest’ in the stock over time or based on certain milestones. Actual issued shares, may not be technically outstanding

Unlike options, restricted stock vesting translates into ownership of the stock. Consequently the vesting event is taxable (significant rights of forfeiture lapse) Taxes are based on the FMV of the stock as of the vesting date. Typically the stock is worth much more compared to its grant price resulting in a high tax impact.
§83(b) election

§83(b) allows for a current inclusion of restricted property, prior to vesting.

In other words, one can elect to have the property taxed at its current (grant) value currently, as opposed to in the future when it is worth more. Note the risks addressed prior.

How? A simple election....
§83(b) Election

Written Statement that includes:

1. Name, address, SSN
2. Description of the property (restricted stock of XX Co.)
3. Date the property was transferred
4. Taxable Year the Election is made for (201X)
5. Nature of restrictions the property is subject to (for instance vesting periods)
§83(b) Election (cont.)

6. FMV at the time of transfer, $x.xx per share for XX shares, for a total value of $XX.xx
   >This should be based on a qualified valuation.

7. Any amount(s) paid for the property transferred

8. Disclosure that a copy of this statement has been provided to the [Company].

9. Dated, signed
§162(m)

More ‘operative’ in nature rather than a compliance requirement, no forms. It is a penalty for overpaying public company executives.

- Monitor annually
- ensure if compensation is performance based that it is properly documented and approved to meet the exclusion requirements
- pro-actively consider stock prices, awards, and benefits when planning compensation to ensure the threshold is not met.
Miscellaneous Tax thoughts…

• Use of a compensation committee (if a public company)
• have employees report annually any disqualifying dispositions (this is when ISOs are tax deductible to the Company!)
• Use the §83(b) election.... With caution
• Understand how phantom stock, SARs, and hybrid compensation is treated before issuing/accepting
• Stay current with valuations. Though un-litigated, IRS will pursue – only a matter of time
Miscellaneous Tax thoughts…

• Stay current with valuations. Regarding restricted stock, if no §83(b) election in place, FMV of the vesting award is includible in an employee’s wages as it vests (and subject to normal taxes and withholding) UPON VESTING.

• Remember that a stock’s basis is what a person ‘paid’ or was taxed on.

• Vesting (absent an effective election) and/or exercise is when the capital gain clock starts, not upon grant (generally when you own the stock/when substantial right of forfeiture lapses)
ASC Topic 718: Compensation – Stock Compensation

Determine if award an equity or liability based award? Financial accounting is concerned with Equity v. Liability, not statutory v. non-statutory.

- Equity awards valued at the date of grant. Expensed over vesting period

- Liability classified awards are remeasured at fair value at the end of each reporting period, until settled (e.g. settlement date = measurement date)
  - Typical of SAR’s (stock appreciation rights)
Liability-based Awards

If an award does **NOT** have a market, performance, or service condition, generally it would be classified as a liability-based award.

In other words, amount should be considered due in the future and classified as such. (And, the presence of an IRC §83(b) election if applicable does not impact the financial determination.) Stock Appreciation Rights (SARs)

Date of settlement (payment) = measurement date of award. Thus liability accounting, and mark to market the liability annually.
Equity-based Awards

When awards are affected in their exercise price, exercisability, or other factors used in determining award’s fair value on account of a:

- MARKET condition (achievement of external value);
- PERFORMANCE condition (employee service and company goal);
  or
- SERVICE condition (employee service)

There remains uncertainty as to obligation (in tax terms, a significant risk of forfeiture).

**THESE ARE CLASSIFIED AS EQUITY AWARDS.**
Equity-based awards - details

Once Liability v. Equity is determined, and fair value is determined, there are a few additional inputs:

1. Grant date – the date on which the stock-based compensation is measured
2. Requisite Service Period – the period over which the awards are expensed (generally the vesting period)
   
   1. This may differ from the Term used in Black-Scholes
Equity-based awards - details

Key factors affecting stock option expense

• Valuation (selection of and development of assumptions)
• Forfeiture assumption (estimated with true-ups)
• Vesting conditions (service, performance, market)
• Amortization (straight line or graded vesting methods)
• Fair value computation e.g. Black-Scholes, Lattice Model, etc.
## Forfeitures

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<th>Yr 1</th>
<th>Yr 2</th>
<th>Yr 3</th>
<th>Yr 4</th>
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<tr>
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<td>100,000</td>
<td>90,000</td>
<td>81,000</td>
<td>72,900</td>
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<tr>
<td>Options Forfeited</td>
<td>(10,000)</td>
<td>(9,000)</td>
<td>(8,100)</td>
<td>(7,290)</td>
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<tr>
<td>Ending</td>
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<td>81,000</td>
<td>72,900</td>
<td>65,610</td>
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<tr>
<td>Annual Forfeiture Rate</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Expense calculation is based on fair value of 65,610 options.
Black-Scholes

Time to determine the fair value of the options, Black-Scholes is most common, Binomial Lattice is also permitted, Monte Carlo more sophisticated.

For calculating the Black-Scholes model you will need:
- FMV of stock (valuation)
- Exercise Price
- Term (including forfeitures)
- Expected Dividend Yield
- Risk Free Interest Rate
- Expected Volatility
Some details - TERM

Term considerations include historical exercise patterns, vesting and volatility patterns, future expectations, and forfeiture rates.

Forfeiture rates are also used to determine the number of equity instruments expected to vest.
Some details - Volatility

For private companies, generally a set of comparable public companies can be used as an input, must be ‘reasonable’ and ‘supportable’.

Being a private company that has a unique transforming business model that is unlike anything on the market does NOT mean it does not have comparables.

Ok to use a 3rd party to assist in Black-Scholes inputs
The Calculation

Schedule the awards expected to vest each period. *

Equity awards (unless modified) use an option pricing model employing the price as determined upon grant.

Liability awards use the price as determined at the end of each period.
* Of note, expected vesting

Forfeitures of pre-vested shares impacts recognized compensation cost. You can adjust for these!

> reverse all prior related recognized compensation costs
> does not impact term assumptions prospectively or retrospectively

Forfeitures of vested shares (lapse of un-exercised awards) do NOT affect compensation. They should, however, be considered in developing term assumptions.
* Of note, expected vesting

Alternate vesting methods and expensing may be used:

**Cliff vesting:** straight line (expense same for each period)

**Graded vesting:** modified straight line (expense options that vest each period)

**Graded vesting:** Accelerated (options vesting each period treated as a separate award; amortized on a straight line basis from grant to vesting date)
Back to the calculation…. 

\[
\frac{(\text{Shares vested} \times \text{market price}^1)}{\text{service period}} - \text{recognized unvested forfeiture values} = \text{EXPENSE}
\]

^1 fair market value of the option computed AS OF grant date using an option pricing model such as Black-Scholes

Liability: current FMV value – in other words, mark to market the liability every balance sheet date
Nuts and Bolts

Grant through Vesting
Dr Comp Expense xxxxx
Cr APIC xxxxx
Book comp. expense over the service period

Dr Deferred tax asset xxx
Cr Deferred tax provision xxx
Book tax impact of compensation expense
Nuts and Bolts

Upon Exercise

Dr Cash xxx
Dr APIC^a xxx
Cr Common Stock xx
Cr APIC (balance of entry) xxx

^a(reverse original entry)
Nuts and Bolts

Upon Exercise
Dr Deferred tax provision  xxx
Cr Deferred tax asset  xxx
Reverse original entry
Preferred Stock

ASC 480 – "Distinguishing Liabilities from Equity"
Deals with the mark-to-market of mandatorily redeemable preferred stock **AND** Freestanding Warrants

- classified as liabilities, revalued each period
- need current valuations
Contact Information

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Valuation of Equity Securities of Privately Held Companies

Raphael Meyara, CEO
AlgoValue Inc.
Why do we need to valuate an equity security?

- Investment purpose
- M&A and Pre-IPO secondary marketplace platform
- Tax (409A)
- Financial Reporting (PPA, ASC 820)
- ESOP (Employee Stock Option Plan, ASC 718)
- Legal
Types of Equity Securities?

- Preferred Stock
- Common Stock
- Warrants
- Stock Options
- Convertible debt
Economic Rights measurable and taken into account into valuation methods:

1. Preferred Dividends (Cumulative)
2. Liquidation Preference
   - Non Participating
   - Participating (total cap and force conversion)
Right Associated with Preferred Stock

✓ Voting Rights non measurable and non taken into account into valuation methods:

1. Voting rights and veto rights
2. Board composition
3. First refusal rights
4. Management rights
5. Information rights
Valuation Approaches

✓ Market Approach
  • Similar Companies M&A
  • The BackSolve Method
  • Multiples

✓ Income Approach
  • Discounted Cash Flow Method
  • WACC
Selection of a Method for Valuing Equity Securities

Criteria should be considered:

1. Reflects the going-concern status of the company;

2. The method assigns some value to the common shares unless the company is being liquidated;

3. The results of the method can be either independently replicated by other valuation specialists using the same underlying data and assumptions;

4. The complexity of the method is appropriate to the enterprise’s stage of development.
Selection of a Method for Valuing Equity Securities

1. Probability Weighted Expected Return Method
2. Option Pricing Method
3. The current Value Method
4. Hybrid Method
1. When should we apply a DLOM?

2. Sources of DLOM calculation:
   a. Data market
   b. Protective Put
   c. Finnerty Model
   d. Asian protective put
Company X is a developer of networking products, both hardware devices and the software necessary to support them. The Company was founded in 2008, and both its headquarters and manufacturing facilities are located in California. Until December 2010, the Company’s sole source of equity capital was the founders and their family and friends. Equity capital at that time consisted solely of 4,000,000 outstanding shares of common stock.

In late December 2010, the Company completed an offering of Series A convertible preferred stock to the XYZ Venture Capital Group. The issue comprised 1,000,000 shares, convertible into common at the ratio of one share of common for each share of preferred converted. The preferred shares were issued for $35 per share, with total proceeds to the Company of $35,000,000. In addition to the conversion feature, the Series A preferred stock had the following terms and conditions:

Liquidation preference. Payments upon a dissolution, merger, acquisition, or sale of assets are to be paid first to Series A preferred shareholders at $35 per share. Any amount remaining is paid to the common shareholders based on their respective ownership. Series A preferred does not participate beyond this initial preference.
Discount for Lack of Marketability
## OPM Break Points

<table>
<thead>
<tr>
<th>Payoff</th>
<th>Range</th>
<th>Distribution</th>
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<tbody>
<tr>
<td>1st Payoff</td>
<td>Up to $35,000,000</td>
<td>100% to preferred shareholders</td>
</tr>
<tr>
<td>2nd Payoff</td>
<td>$35,000,000 to $175,000,000</td>
<td>100% to common shareholders</td>
</tr>
<tr>
<td>3rd Payoff</td>
<td>Over $175,000,000</td>
<td>80% to common shareholders, 20% to preferred shareholders</td>
</tr>
</tbody>
</table>
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