Transaction Issues With Equity Compensation

2013-Issue 33—This edition of *Tax Advisor Weekly* discusses some of the common compensation tax issues that occur when U.S. corporations are acquired.

Recently, there has been an increase in the number of strategic mergers and foreign inbound investments. These types of transactions raise numerous U.S. tax issues relating to equity compensation. If not handled appropriately, the tax exposure to the acquired corporation and its executives can be significant.

Overview of Equity Compensation

Companies often grant their employees equity compensation awards to retain and reward key talent for the performance of services. These awards typically vest over time based on the employee's continued employment. The most common forms of equity compensation are stock options and restricted stock awards. Stock options are either nonqualified stock options (NQSOs) or incentive stock options (ISOs).

NQSOs are normally not taxable to the recipient when granted, but are taxable upon exercise. This assumes that the options have an exercise price equal to or greater than the stock's fair market value, in order to comply with IRC Section 409A. Upon exercise, the excess of the fair market value of the stock over the exercise price (the "spread") is taxable to the employee as ordinary income. The company is entitled to deduct the spread in the year of exercise.

ISOs are stock options that are eligible for favorable tax treatment under Sections 421 and 422. Specifically, an ISO allows an individual to exercise an option without recognizing income if the individual does not dispose of the underlying shares within two years from the date of grant and one year after exercise. Many requirements must be satisfied for an option to qualify as an ISO. ISOs are not taxed when exercised. Instead, to the extent the employee satisfies the holding period requirements, any gain realized upon the subsequent sale of the shares is entitled to capital gains treatment. The company has no withholding requirements. In addition, the company is not entitled to a deduction upon ISO exercise, unless the holding period requirements are not satisfied.

A restricted stock award is a transfer of company stock in which the recipient's rights in the stock are restricted until the restrictions lapse — that is, the shares become vested. Once the vesting requirements are satisfied, an employee owns the shares outright and may hold or dispose of them at any time. Restricted stock is taxable to employees when the shares are no longer subject to a substantial risk of forfeiture. Shares are generally no longer subject to a substantial risk of forfeiture when the employee can terminate employment and still receive his/her benefits (at the time of vesting) under the plan. The fair market value of the shares at the time of vesting is included in the employee's taxable ordinary income and is deductible to the company in the year in which the employee is taxed.

Stock Options in a Transaction

Long-term incentive plans, grant award agreements, employment contracts and change in control agreements affect the treatment of an employee's stock options during an acquisition. These agreements may require acceleration of vesting, assumption, substitution or cancellation. In strategic transactions, the acquiring entity often assumes the outstanding options.

Options Rollover

In the event an acquiring corporation assumes the outstanding ISOs, the favorable tax status of the ISOs will only be preserved if the assumption and rollover complies with the requirements of IRC Section 424. Similarly, Section 409A addresses the assumption and rollover of NQSOs in a transaction. Section 409A imposes election, payment and funding requirements on "nonqualified deferred compensation" plans. If a nonqualified deferred compensation arrangement subject to Section 409A fails to meet, or is not operated in accordance with, the requirements of Section 409A, then compensation deferred under the arrangement may become immediately taxable and subject to an additional 20 percent excise tax.

Specifically, for a rollover of options to maintain ISO status and comply with the requirements of Section 409A, the following conditions must be satisfied:

- The total spread (the excess of the aggregate fair market value of the shares subject to the option over the aggregate option exercise price) of the option after substitution cannot exceed the total spread of the option that existed immediately prior to the substitution (the "spread test");
- On a share-by-share comparison, the ratio of the option exercise price to the fair market value of the shares subject to the option immediately after the substitution cannot be greater than the ratio of the option exercise price to the fair market value of the units subject to the option that existed immediately prior to the substitution (the "ratio

test”);

- The substituted option must contain all of the terms of the option, except to the extent such terms are rendered inoperative by the corporate transaction; and
- The substituted option must not provide the option holder with additional benefits that the option holder did not have under the option.

If these conditions are satisfied, the options will retain their status as ISOs. Similar requirements are imposed under Section 409A for NQSOs.

Options Are Cashed Out

Alternatively, the transaction may provide for all outstanding stock options to be cashed out at the close of the deal. In this situation, the employee receives ordinary income equal to the cash-out payment (the excess of the merger consideration over the exercise price) for all outstanding stock options. In the case of an ISO, the cash-out will disqualify the award, and the taxation rules related to nonqualified stock options will apply. Employees are required to include the cash-out payment in their taxable income. Although the acquiring corporation typically pays the cash related to the options, the target company is generally entitled to the deduction in the pre-close period.

The cash-out of stock options can be paid at the time of the merger or on the same schedule and conditions applicable to the shareholders (“earn-out payment”). To comply with Section 409A, the earn-out period must not exceed five years.

Restricted Stock in a Transaction

Frequently, restrictions related to restricted stock lapse when an acquisition occurs. Absent a Section 83(b) election at grant, the accelerated vesting of the restricted stock will result in ordinary income to the employee at the time of vesting (equal to the number of shares vested times the merger consideration). The amount of ordinary income recognized by the employee is deductible to the company in the post-close period.

Transactional Bonuses

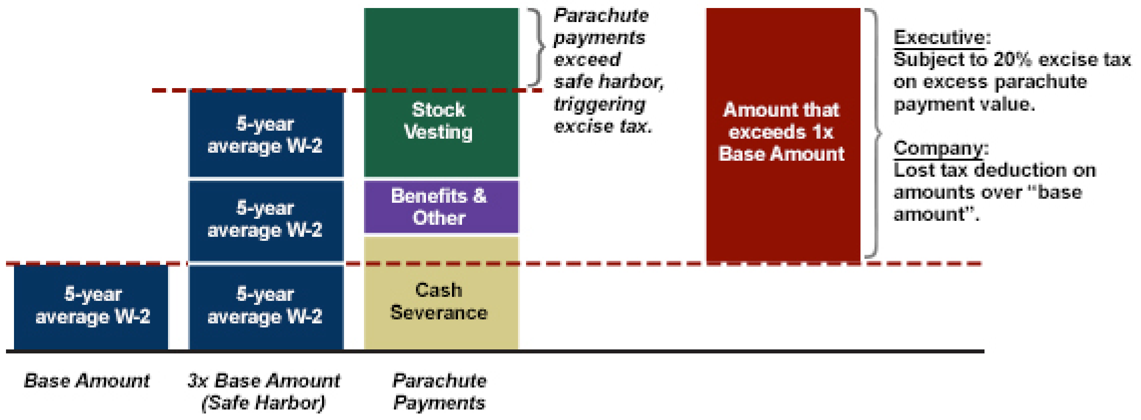
While public companies reward their executives with equity compensation (options or restricted stock), privately held companies generally provide cash bonuses and/or restricted stock units. These cash bonus and restricted stock units generally pay out upon a liquidity event, such as a change in control. Often the acquiring company wants to retain the target executives after a change in control and desires to restructure the cash payment or restricted stock units. Generally this is not permissible under Section 409A. However, there is an exception in the event of a change in control if the amounts are substantially unvested. Under the exception, the modification would need to be made prior to the change in control, and the vesting would be removed upon the change in control. The modification must also satisfy the following requirements: (1) be arm’s-length negotiations, and (2) be subject to a risk of forfeiture (i.e., the employee must be employed three years after a change in control).

Golden Parachute Rules Under Section 280G

When a corporation is acquired by another company, both the corporation and key executives may be subject to significant adverse tax consequences under the golden parachute provisions of IRC Section 280G. Under these provisions, a payment to an executive of $1 above the golden parachute “safe harbor” limit creates large penalties for both the executives and the company. Depending on the circumstances and the number of executives affected, the cost to the company and the executives can be significant.

When a change in control of a corporation occurs, the golden parachute provisions provide substantial penalties should the executive receive a payment equal to or greater than 300 percent of the executive’s average compensation over the prior five years. Typical situations where the golden parachute penalties are triggered involve companies that have significant equity-based compensation awards outstanding (e.g., stock options, restricted shares, performance shares, stock appreciation rights), of which vesting accelerates upon a change in control.

When an executive receives payments exceeding the safe harbor amount, Section 280G disallows an income tax deduction for “excess parachute payments” and Section 4999 imposes a 20 percent excise tax on the recipient of any “excess parachute payments.” The following chart illustrates the mechanics of Section 280G.



In addition, many executives have a clause in their employment contract stating the corporation must gross up any golden parachute excise tax. Consequently, the corporation is liable for the tax penalty to the executive, the lost corporate deduction, and all federal and state income taxes that the executive would be required to pay because the corporation paid the executive's excise tax. Note that Section 280G consequences apply even if the key executive remains employed with the company.

Alvarez & Marsal Taxand Says:

While an acquisition may result in a multitude of tax issues and increased demands, the tax implications related to the equity compensation awards must be addressed from both an employee and company perspective. Not only should corporations try to maximize deductions to increase the purchase price, but they should also be sensitive to the tax treatment of their employees in connection with a potential sale. Understanding the potential adverse tax treatment on the individual and the appropriate way to avoid these taxes will help improve employee morale and the likelihood of retaining key talent through this trying process.

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