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EQUITY COMPENSATION STRATEGIES FOR EMERGING GROWTH COMPANIES

By Timothy J. Sparks

Emerging growth companies are typically strapped for cash and are often unable to offer benefit packages that can compete with more mature companies. Emerging growth companies therefore tend to rely heavily on stock and stock options and their potentially huge financial rewards to attract and retain key talent. Despite the success and popularity of equity compensation among many of today's leading edge companies, the rapidly changing legal and business environment is forcing many emerging growth companies to reassess their equity compensation strategies.

Today, emerging growth companies must contend with increasingly active institutional investors on matters relating to equity compensation. In addition, the SEC continues to adopt regulatory changes that are intended to make management and boards of directors more accountable to shareholders with respect to executive compensation practices.

The accounting treatment of equity compensation programs also continues to evolve. Recently, as a result of an effort led by emerging growth and technology companies, the financial accounting standards board, or FASB, fell short in its efforts to mandate new accounting rules applicable to equity compensation, most notably employee stock options. Had they been adopted, the proposed rules would have forced many companies to curtail their equity compensation programs. FASB did, however, succeed in changing the financial disclosure requirements applicable to employee equity programs.

The Revenue Reconciliation Act of 1993 (the "1993 Tax Act") has also had a significant affect on equity compensation strategies. Among other things, the 1993 Tax Act restored a potentially significant differential between ordinary income and capital gain rates for high tax bracket individuals, increased the alternative minimum tax ("AMT") rates and created a new tax preference for qualified small business stock.

Notwithstanding these and other developments, emerging growth companies continue to embrace equity compensation for their employees. This article reviews this equity compensation environment and offers specific equity strategies for emerging growth companies.

WHY EQUITY COMPENSATION?

Companies typically use stock and stock options to further two fundamental corporate objectives: (1) to promote the company's growth, development and financial success by providing employees with additional incentives and with an ownership interest; and (2) to enable companies to attract and retain the

services of those individuals considered essential to the company's success by offering them an opportunity to participate in the financial success of the company.

WHAT MAKES EMERGING GROWTH COMPANIES DIFFERENT?

Emerging growth companies need to conserve cash to fuel their growth and as a result, tend to avoid compensation programs that involve cash payments. Moreover, emerging growth companies are extremely sensitive to the financial accounting treatment of compensation programs and generally structure such programs so as to minimize their impact on the company's earnings.

For emerging growth companies, equity compensation is particularly attractive since it allows the company to offer powerful financial incentives to employees without using cash. In addition, existing accounting rules allow companies to transfer substantial economic benefits to employees using stock or stock options with a minimal impact on the company's earnings. From the employee's perspective, stock options offer the opportunity to participate in the company's success (*i.e.*, through appreciation in the value of the underlying option shares) without risking capital. Stock purchase and stock option programs can also be structured to deliver significant tax benefits to employees relative to cash compensation. It is primarily for these reasons that stock options and stock purchase arrangements represent the key ingredients of the compensation strategies of emerging growth companies.

STOCK OPTIONS - THE STARTING POINT

Stock options are contracts that allow the holder (the "optionee") to purchase stock at a fixed price. Even if the market value of the stock rises, the optionee may purchase the stock at the low price guaranteed by the option contract. There are essentially two types of compensatory stock options: incentive stock option ("ISOs"), which are tax-favored options created under Section 422 of the Internal Revenue Code of 1986 (the "Code"), and non-statutory or non-qualified stock options ("NQSO").

INCENTIVE STOCK OPTIONS

Section 421 of the Code provides favorable tax treatment with respect to stock options that meet the requirements of Section 422 of the Code. In general, an ISO allows an employee to purchase stock at a discount without paying tax until the stock is sold, at which time any gain will be taxed at favorable long-term capital gain rates. The ISO requirements include the following:

- **Plan** - the options must be granted pursuant to a "plan" that specifies the number of shares that may be issued under options and the employees (or class of employees) eligible to receive options. The plan must be approved by the shareholders of the company within one year of its adoption by the board of directors;
- **Option Price** - the option exercise price must not be less than the fair

market value of the shares (as determined by the board of directors in good faith) on the date of grant. Special rules apply in the case of ISO grants to employees who are 10% shareholders. §§422(b)(6), (c)(5);

- **Option Term** - the option may not be exercisable for a period of longer than ten years after grant (five years in the case of option grants to 10% shareholders);
- **Employees Only** - the option may only be granted to a person who is an employee of the company or its parent or subsidiaries on the date of grant;
- **Employment** - the option may be exercised by the employee while an employee or in any event, no later than three months after termination of employment (except in the case of termination due to disability, after which Section 422(b) requires that an ISO be exercised for up to twelve months, or death, which is subject to no limitations); and
- **\$100,000 Limit** - the fair market value of ISO shares (as determined on the grant date) that may be purchased for the first time in any calendar year may not exceed \$100,000. To the extent this limit is exceeded, the excess shares will be taxed at purchase as if acquired pursuant to exercise of an NQSO.

There are no federal income tax consequences upon the grant of an ISO. On exercise, the employee incurs no tax liability unless the optionee is subject to alternative minimum tax ("AMT") under Section 55 of the Code (discussed below). Upon sale or disposition of the shares (assuming that the sale does not occur within one year after the date of option exercise nor within two years after the date of option grant), any gain or loss is taxed as the employee's long-term capital gain or loss.

Currently, the maximum federal tax rate on net capital gain is 28% compared to the maximum (nominal) marginal tax rate on ordinary income of 39.6%. The combination of a tax deferral together with favorable long-term capital gain rates makes ISOs an important part of equity compensation strategies for high tax bracket employees.

If the ISO shares are disposed of before the end of these holding periods (*i.e.*, a "disqualifying disposition"), the employee will recognize ordinary income equal to the excess of the value of the shares at the time of option exercise (or at the time of such disposition, if less) over the amount paid for the shares. Any ordinary income recognized by the employee upon a disqualifying disposition is not currently subject to withholding by the employee's employer. IRS Notice 87-49, 1987-2 C.B. 355. However, the IRS has informally expressed its intention to require withholding on disqualifying disposition income in the future. The excess, if any, of the sales price over the value of the shares at the time of option exercise is taxable as capital gain, which will be long-term capital gain if the shares have been held by the employee for more than one year prior to sale.

The employer is entitled to a deduction for federal income tax purposes only to the extent that the employee recognizes ordinary income upon a disqualifying disposition of the ISO shares. §421(a)(2). Notwithstanding the potential loss of a tax deduction, many emerging growth companies continue to grant ISOs because of the potential tax savings available to employees and because, as a practical matter, the employer deduction is usually available as a result of employee disqualifying dispositions.

Under Section 424(h), if the terms of an ISO are modified, extended, or renewed, the modification, extension or renewal is deemed to be the grant of a new option. A modified ISO will be disqualified as an ISO unless it meets the requirements of Section 422 of the Code at the time of the modification. For

example, a modified ISO ceases to qualify as an ISO if the option price is less than the fair market value of the option shares at the time of the modification. If the deemed new option meets the requirements of Section 422 of the Code at the time of the modification, the option will remain an ISO but the date of grant will be reestablished as the date of the modification for purposes of the ISO holding periods.

To constitute a modification under Section 424(h) of the Code, there must be a change in the option terms that gives the optionee additional benefits under the option. A modification may result even though the optionee does not actually benefit from the change in the terms. The following are example of modifications:

- a change provides more favorable terms for payment for the stock purchased under the option, such as the right to tender previously acquired stock.
- a change that provides an extension of the period during which an option may be exercised, such as after termination of employment.
- a change that provides an additional benefit upon exercise of the option, such as the payment of a cash bonus.

A change that provides, either by its terms or in substance, that the optionee may receive an additional benefit under the option at the future discretion of the grantor, is considered a modification both at the time the option is changed and at the time the benefit is actually granted. The following are changes that do not constitute modifications under Section 424(h) of the Code:

- a change in the price of outstanding options to reflect a decline in the value of the corporation's stock resulting from a spin-off. This change reflects a corporate transaction as defined in Section 424(c) of the Code rather than a modification.
- no modification occurs where the employer cancels its right of first refusal with respect to option stock, provided the cancellation is necessary to equate the rights of ISO holders with the rights of all shareholders.
- adding a provision to provide for accelerated vesting upon a change in control is not a modification.

ALTERNATIVE MINIMUM TAX

As indicated above, an employee who receives an ISO and acquires shares upon its exercise will not recognize taxable income until the shares are sold or otherwise disposed of. The employee may, however, become subject to alternative minimum tax ("AMT") liability in connection with exercising an ISO. AMT is calculated by applying a tax rate of 26% to the first \$175,000 and 28% to amounts in excess of the \$175,000 of an taxpayer's alternative minimum taxable income ("AMTI"), which is equal to (1) taxable income adjusted for certain items, plus (2) items of tax preference, less (3) an exclusion of \$45,000 for joint returns, \$33,750 for individual returns and \$22,500 for married taxpayers filing separately. The exclusion amounts are reduced by an amount equal to 25% of the amount by which AMTI exceeds \$150,000, \$112,500 and \$75,000, respectively.

As a general rule, the excess of the value of shares purchased upon exercise of an ISO on the date of exercise over the exercise price is included in the calculation of the taxpayer's AMTI as a tax adjustment item. §56(b)(3).

However, the adjustment may be computed other than on the purchase date where the shares purchased upon ISO exercise are either (1) subject to a "substantial risk of forfeiture" (as defined in Section 83 of the Code) at the time of purchase, or (2) sold in the same year as the purchase at a price below the fair market value on the purchase date. Any AMT paid in connection with ISOs generally is creditable against future years' income tax so as to avoid a "double tax" on the same income.

NON-QUALIFIED STOCK OPTIONS

An NQSO is basically any compensatory option that does not meet the requirements applicable to ISOs. Since NQSOs are free of the technical requirements of Section 422 of the Code, NQSOs are far more flexible than ISOs. For example, NQSOs may be issued to non-employees, such as consultants and non-employee directors, or may be issued with an exercise price that is set at a discount below fair market value.

The taxation of NQSOs is governed by Section 83 of the Code. Section 83 of the Code determines the tax treatment of property transferred in connection with the performance of services. Under Section 83, neither the grant nor the vesting of an NQSO is a taxable event, provided the NQSO does not have a readily ascertainable fair market value at the time of grant. §83(e)(3). Whether an option has a readily ascertainable fair market value is determined under Treasury Regulations. As a practical matter, these rules make it virtually impossible for a typical compensatory option to have a "readily ascertainable" fair market value. As a result, Section 83 generally applies to the transfer of stock only upon the exercise or disposition of the NQSO. Reg. §1.83-7(a).

WHAT IS READILY ASCERTAINABLE FAIR MARKET VALUE?

An option has a readily ascertainable fair market value at the time of grant (and is therefore taxable at that time) if the option either (1) is actively traded on an established securities market, or (2) if not so traded, passes four tests. Reg. §1.83-7(b)(1), (2):

- **Transferability** - the option must be transferable by the optionee;
- **Exercisability** - the option must be exercisable immediately in full by the optionee;
- **Free of Restrictions** - neither the option nor the property underlying the option may be subject to any restriction that has a significant effect upon the option's value;
- **Ascertainable Option Value** - the fair market value of the option privilege must be ascertainable. For this purpose, the value of the entire option privilege must be measurable with reasonable accuracy.

Typically, employee stock options become exercisable over time based on the employee's continued employment. Options are generally non-transferable and are commonly subject to resale restrictions. Consequently, virtually all employee stock options will not be considered to have a readily ascertainable fair market value at the time of grant and as a result, the optionee will not recognize any taxable income at that time. Instead, Sections 83(a) and 83(b) will apply at the time the employee exercises the option or otherwise disposes of the option.

Upon exercise of the option, the optionee will generally recognize ordinary compensation income for federal tax purposes measured by the excess, if any, of the then value of the shares over the exercise price. However, this rule does not apply if the purchased shares are subject to a "substantial risk of forfeiture" (*i.e.*, "unvested"). This is the case when, for example, the shares may be repurchased by the company at the employee's cost or forfeited if the employee's employment terminates. No tax will be imposed at the time of purchase of non-vested shares unless the employee files an election with the IRS pursuant to Section 83(b) the Code within 30 days after the date of exercise.

In the absence of a Section 83(b) election, the employee will be taxed (and the employee's long-term capital gain holding period will begin) at the time(s) the shares vest. Normally, vesting occurs when the repurchase option lapses with respect to such shares. When the shares vest the employee will recognize compensation income equal to the difference between the value of the shares vesting and the option exercise price (*i.e.*, the "Spread"). If a Section 83(b) election is timely filed, the non-vested shares will be treated for federal income tax purposes as if they had been vested at the time of exercise. In this event the employee will be taxed at the time of purchase based on the Spread at that time. An employee would ordinarily file an election under Section 83(b) if there was little or no difference between the value of the purchased property and the amount paid or if the employee expected significant appreciation in the value of the property prior to the vesting date.

If the employee sells or otherwise disposes of the option in an arm's-length transaction, any money or property the employee receives will be taxed under Section 83(a) as if it were received upon exercise. Reg. §1.83-7(a). Upon a non-arm's length disposition of an option not taxed at grant, such as a gift, the employee may recognize compensation income both at the time of the disposition of the option and at the time of the exercise of the option by the transferee.

Option income recognized by an employee is treated as wages for federal income and employment tax purposes and as a result, is subject to tax withholding by the employer out of the current compensation paid to the optionee. Rev. Rul. 67-257, 1962-2 C.B. 359; Rev. Rul. 67-366, 1967-2 C.B. 65. If the employee's current compensation is insufficient to pay the withholding tax, the employee may have to make a direct payment to the employer for the tax liability.

The employer receives a tax deduction in the amount and at the time that the optionee recognizes ordinary income with respect to shares acquired upon exercise of an NQSO, provided the employer properly reports the income so recognized; (prior to the proposed amendments to Reg. 1.83-6 in December, 1994, the employer's deduction was conditioned upon deducting and withholding the income tax attributable to a taxable transfer of property under Section 83).

RESTRICTED STOCK

Under a restricted stock plan, equity securities (typically common stock of the employer) are sold to the employee at either full fair market value or some bargain purchase price. The employee's rights in the stock are generally subject to contractual restrictions on its ownership, usually involving a forfeiture of the purchased shares or the right of the company to repurchase

the shares at the employee's original cost upon termination of the employee's employment with the company. The company's repurchase right generally lapses over time based on the employee's continued employment.

The employee is taxed under Section 83 of the Code when the employee's rights in the stock vest. Vesting occurs when the stock becomes transferable or is no longer subject to a substantial risk of forfeiture §83(a). The employee then recognizes compensation income equal to the excess of the value of the stock at the vesting date(s) over any amount the employee paid for the stock. However, the employee may elect under Section 83(b) to be taxed at the time the employee acquires the stock on the excess of the fair market value of the stock at that time over the amount the employee pays for the stock. Compensation income recognized by an employee in connection with restricted stock is subject to tax withholding by the employer. The employer receives a tax deduction for the compensation income recognized by the employee but only if the employer properly reports the income so recognized. Prop. Reg. §1.83-6(a).

Depending on the value (and purchase price) of the stock, restricted stock can be an attractive way to give key employees a direct ownership interest in the company and align the employee's interests with those of the shareholders. Moreover, if the employee purchases the stock at a discounted price, or if the shares appreciate after the purchase date, the unvested shares create a powerful economic incentive to remain with the company.

ACCOUNTING FOR OPTIONS AND RESTRICTED STOCK

Emerging growth companies are extremely sensitive to the financial accounting consequences of their compensation and benefit programs. As a result, the financial accounting treatment of equity compensation programs is often the most important consideration.

The starting point to understanding the current financial accounting consequences of stock compensation programs is Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." This Opinion establishes the generally accepted accounting principles for measuring the amount of compensation to be recorded on a company's books to reflect its issuance of stock options and equity compensation.

For financial accounting purposes, stock compensation programs are classified as compensatory or non-compensatory. Compensation expense is recognized, if at all, only in connection with compensatory plans. In general, under APB 25, all employee equity programs are compensatory except for certain broad-based programs, such as an employee stock purchase plan under Section 423 of the Code.

For compensatory stock plans, the most significant factor in the determination of the compensation cost is the "measurement date." Under APB 25, the measurement date is the first date that both the number of shares and the purchase price, if any, are known. At that date, the compensation is measured as the excess, if any, of the value of the stock at that date over the employee purchase or option price, if any. Thus, in a typical option grant, the measurement date is the date of grant, since both the number of shares and the option price are known. Since ISOs and most NQSOs are typically granted with a purchase price equal to the then value of the stock, most option grants do not involve any compensation expense even though the stock may

appreciate substantially after the date of grant. If on the measurement date the value of the stock exceeds the purchase price (*i.e.*, a discount NQSO), the employer must recognize a compensation expense against its earnings for the company's financial periods to which the employee's service relates (*e.g.*, over the vesting period).

Whether the employer must recognize a compensation expense for financial accounting purposes in connection with the award or purchase of restricted stock under a typical restricted stock program usually depends on whether the stock is issued or sold at a discount from its fair market value. Under current rules, compensation expense is recognized to the extent of any difference between the value of the stock at the time of the award and the purchase price, if any. The amount so recognized will generally be allocated on a ratable basis over the period during which the services are performed (*e.g.*, the vesting period).

However, the restricted stock grant may be viewed as a "variable plan," requiring periodic adjustments to account for changes in the market value of the stock if the number of shares or the purchase price are not known. This treatment occurs when restricted stock grants are contingent on performance milestones, or, in certain circumstances, are subject to put rights held by the purchaser or repurchase rights held by the employer.

For the past three years, the Financial Accounting Standards Board ("FASB") has attempted to change the accounting rules applicable to employee equity compensation. In June 1993, the FASB issued an Exposure Draft on accounting for stock options, which would have required employers to recognize a compensation expense for the "fair value" of employee stock options calculated using an option valuation model, such as Black-Scholes. Responding to a tidal wave of protest led by emerging growth and technology companies, the FASB retreated from its proposal and in December 1994, decided to allow companies to choose between continuing to report equity compensation expense under APB 25 or under the new standard. On May 9, 1995, the FASB released a draft of its final standard. In the draft, the FASB encourages companies to adopt the new "fair value" standard, which requires companies to recognize a compensation cost for most employee stock awards. Companies that choose not to adopt the new standard may continue to account for equity compensation under APB 25. However, regardless of which accounting standard a company chooses, the company must compute and disclose, by means of a financial statement footnote, the compensation cost of equity compensation using the complex rules of the new fair value standard.

ANTICIPATING AN INITIAL PUBLIC OFFERING

The period preceding an initial public offering ("IPO") presents a number a number of unique equity compensation planning opportunities. In anticipation of the significant increase in the value of the company's stock that results from an IPO, employees with stock options can take action prior to the IPO to minimize the tax impact of exercising their options and selling their shares. Employers, too, can take certain actions to take advantage of this unique event to enhance their equity compensation programs.

Typically, the valuation of the company's stock climbs dramatically in the months preceding the IPO. For example, it is not uncommon for stock to be valued at as little as one-fifth the IPO price 12 months prior to the IPO. As a result, employees with options will generally benefit by exercising their options

in advance of the IPO. In the case of NQSOs, this reduces the taxable income associated with option exercise, which is based on the excess of value of the stock at the time of exercise over the option exercise price. In addition, exercising an option commences the employee's long-term capital gain holding period. If the employee sells the shares at least one year later at an appreciated (post-IPO) price, the resulting gain will be taxed at favorable long-term capital gain rates; had the employee postponed exercising the option, he or she would have to recognize income based on the difference between the presumably higher valued stock at exercise over the option exercise price.

Employees with ISOs can follow a similar strategy for purposes of minimizing the AMT impact associated with ISO exercise. If the employee exercises the ISO well in advance of the IPO, the AMT "spread" between the value of the shares and the option exercise price will likely be much smaller than the spread that will exist closer to or after the IPO. Since the AMT calculation includes the ISO exercise spread, the employee can minimize the AMT impact of ISO exercise by exercising when the shares are at a relatively low valuation. In addition, exercising the ISO commences the employee's one-year ISO and long term capital gain holding period, which will allow the employee to sell the ISO shares at a subsequent date subject to favorable long term capital gains rates.

These strategies are available even if the options are not yet vested if the Company permits an "early exercise" of the option. Early exercise allows the employee to exercise the option even as to unvested shares, subject to the company's right to repurchase the unvested shares at the employee's original cost upon the employee's termination of employment. The company's repurchase right lapses at the same rate as the option vesting schedule, based upon the employee's continued employment with the company.

By purchasing shares in this manner and filing an election under Section 83(b), employees can take advantage of the same tax planning opportunities described above. Since the unvested shares are considered to be subject to a "substantial risk of forfeiture" for purposes of Section 83 of the Code, an 83(b) election can minimize the spread for income tax and AMT purposes in the case of NQSOs and ISOs, respectively.

Employees with ISOs should be careful to avoid converting a portion of the ISO into an NQSO as a result of adding an early exercise feature. Section 422(d) of the Code, which sets a \$100,000 limit on the value of ISO shares that can be purchased for the first time in any calendar year, does not distinguish between vested and unvested shares. As a result, all of the unvested option shares that can be purchased under an early exercise feature must be included in the \$100,000 calculation. To the extent the value exceeds \$100,000, the option will be converted into an NQSO.

There are pre-IPO strategies available to the employer as well. For example, in the months preceding the IPO, when the stock valuation is low relative to the IPO price, the employer can grant attractively priced options to employees. This gives the employer a powerful recruiting tool to help attract key personnel. These options can be granted as NQSOs or as ISOs provided, however, that in the case of ISOs, the board of directors makes a good faith attempt to set the option price at not less than the fair market value at the time of grant. §422(c)(1).

Employers that price their options too aggressively in the year preceding an IPO may invite SEC comment. In particular, the SEC may contend that the employer valued its stock too low when it granted its options, resulting in options granted with an exercise price at a discount from the "true" value of

the stock. This, in turn, would require the company to reduce its reported earnings to reflect the compensation expense attributable to the discount in accordance with APB 25. To mitigate this risk it may be advisable to obtain an independent appraisal of the stock in connection with option grants shortly before an IPO.

Employers should also consider adopting new stock option plans or amending existing plans prior to an IPO to take advantage of an exemption from the compensation deduction limitation of Section 162(m) of the Code, which was added as part of the 1993 Tax Act. In general, Section 162(m) limits a public company's tax deduction for compensation paid to its chief executive officer or any of its four other most highly compensated executives ("Covered Employees") to \$1 million per covered executive per year.

Absent an exclusion, the Section 162(m) deduction limit applies to all compensation paid to a Covered Employee as remuneration for services, including income recognized under Section 83 in connection with exercising NQSOs, vesting in restricted stock, as well as income recognized upon a disqualifying disposition of ISO shares. The \$1 million limit does not apply to compensation that qualifies as "performance-based compensation" under Section 162(m). Compensation attributable to options granted with an exercise price that is at or above fair market value on the date of grant is presumptively performance-based, since it is tied to appreciation in the value of the underlying stock. If the options are granted by two or more "outside directors" (within the meaning of Prop. Reg. §1.162-27(e)(3)) under a shareholder approved plan that limits the number of shares with respect to which options may be granted, any resulting compensation income will not be subject to the deduction limitation of Section 162(m).

Compensation other than compensation attributable to options that meet the above requirements will qualify as performance-based only if four requirements are satisfied:

- **Performance Goals** - the compensation must be paid solely on account of the attainment of one or more pre-established, objective performance goals;
- **Outside Directors** - the performance goals must be established by a compensation committee of the board of directors consisting of two or more "outside directors";
- **Shareholder Approval** - the material terms under which the compensation is to be paid must be disclosed to and approved by the shareholders in a separate vote prior to payment; and
- **Certification** - prior to payment, the compensation committee must certify that the performance goals and any other material terms were in fact satisfied.

In practice, these seemingly simple requirements can be difficult to meet. For example, for performance goals to be considered objective, they must preclude discretion to increase the compensation payable that would otherwise be due upon attainment of the goal. This runs counter to many performance-based plans, which often require some administrative flexibility to adjust performance targets or bonuses to account for unanticipated events, such as the sale of a division or a merger or acquisition. Unfortunately, such flexibility is incompatible with the requirements for performance-based compensation under Section 162(m).

By taking action prior to an IPO, companies can structure their executive compensation arrangements to avoid, to a significant degree, the limitations of Section 162(m). In particular, companies that are anticipating an IPO can adopt new plans and amend existing plans to take advantage of the broad exemption from Section 162(m) that is available to companies that go public. For newly public companies, compensation paid under a plan or agreement that existed while the company was private is excluded from the deduction limit, provided the prospectus accompanying the IPO discloses information concerning those plans or agreements. Prop. Reg. §1.162-27(f). Under this exclusion, for the duration of the "reliance period," compensation attributable to options or other awards made under a plan that was adopted prior to the company's IPO will not be subject to Section 162(m), even as to compensation attributable to options or other awards granted after the company goes public. For this purpose, the "reliance period" lasts until the earliest of (i) the expiration or material modification of the plan or agreement; (ii) the issuance of all employer stock or other compensation that has been allocated under the plan; or (iii) the first shareholder meeting at which directors are elected that occurs after the close of the third calendar year following the calendar year in which the IPO occurs.

Companies anticipating an IPO should consider adopting new plans or amending their existing plans to take advantage of this broad exclusion. For example, companies should consider increasing the share reserve available for issuance under their stock plans and adding plan features that, but for the exclusion, would be difficult to qualify as performance-based. This would include discount options, restricted (bonus) stock as well a broad range of cash-based programs.

PERFORMANCE-BASED EQUITY PROGRAMS

Increasingly, institutional and other shareholders are demanding that executive pay be linked to performance. In addition, the Section 162(m) limit on tax deductibility has forced many companies to modify their compensation programs to qualify as "performance-based" within the meaning of Section 162(m). As a consequence, emerging growth companies, which rely heavily on equity compensation, are increasingly adding performance components to their option and restricted stock programs.

Employers can link equity compensation programs with performance in various ways. Most commonly, option or restricted stock vesting is tied to specific performance milestones. Alternatively, employers can grant so-called "target" or "price appreciation" stock options, which do not become exercisable unless the company's stock appreciates to a particular price.

If the performance milestones are objective and made a part of the original option grant, performance options can qualify as ISOs. In effect, the milestones are considered conditions imposed upon the exercise of the options rather than upon their grant. However, if ISOs are granted subject to subjective performance criteria (e.g., criteria that are discretionary with the plan administrator), the milestones will delay the effective date of grant for purposes of Section 422 of the Code. If the value of the stock at that time is greater than the option price, the option will not qualify as an ISO.

Adding performance objectives to option or restricted stock programs can have undesirable accounting consequences. If the option or stock grants are conditioned upon financial performance objectives or milestones that create

uncertainty as to the number of shares the employee will receive, the program will be viewed as a "variable plan" under APB 25. The compensation element for variable plans can be measured only when both the number of shares of stock that may be acquired and the option and purchase price are known. The total compensation cost can then be measured by the spread between the fair market value of the stock at that time and the amount, if any, to be paid by the employee. Where the measurement date is later than the date of grant, APB 25 requires the employer to recognize the compensation expense at the end of each reporting period after the date of grant and before the measurement date.

It may be possible to incorporate performance objectives into option and restricted stock programs without the adverse accounting consequences described above. A so-called "time accelerated plan" incorporates both employment and performance-based vesting and, as a result, can be structured to avoid compensation expense for financial accounting purposes. Typically, these programs contemplate delayed "cliff" vesting after some period of continued employment, such as five years, with accelerated vesting upon attainment of performance milestones. If the delayed employment-based vesting is not unreasonably excessive, such a program should not be viewed as a variable plan for purposes of APB 25, thereby avoiding the adverse accounting treatment associated with variable plans. One disadvantage of such an arrangement is that the employee's rights vest at the end of the specified period of continued employment, whether or not the employee has attained performance milestones.

OPTION REPRICING

Emerging growth companies often adopt an option repricing program (including a repricing program involving an exchange of options) when employee options are "underwater." An option is underwater when its exercise price exceeds the then fair market value of the stock. While compensation professionals and the financial press are often critical of repricing programs, companies sometimes find it necessary to reprice underwater options to retain and motivate key employees. This can be particularly true for emerging growth companies with their heavy emphasis on options relative to the overall compensation package.

Typically, an option repricing involves the grant of new, lower-priced options in return for cancellation of the employees' older, higher-priced options. As an alternative, some companies merely amend outstanding options to reduce the option price. Except for the price, the other option terms, such as vesting, generally stay the same, although many companies extract some consideration from the optionees, usually in the form of a delayed exercisability of the new option or by extending the vesting term or by reducing the number of option shares. The decision whether to implement an option exchange or option repricing program is often a function of administrative simplicity and the specific provisions of the option plan, which may or may not permit a mere price adjustment.

Option repricing programs involving ISOs raise a number of tax issues. Under either a regrant or repricing program, the adjustment to the option price will be considered a modification to the ISO, which will be considered a new option grant. This treatment will not, by itself, preclude the option from qualifying as an ISO under Section 422, although it will give rise to a new grant date for purposes of the ISO holding periods.

If the exercisability of the old option is carried over to the new option, the new option may exceed the \$100,000 limit of Section 422(d). Section 422(d) provides that to the extent the aggregate fair market value of stock with respect to which ISOs are exercisable for the first time by any individual during any calendar year exceeds \$100,000, such options will be treated as NQSOs. In making this calculation, vesting that occurs after the new option grant but prior to the end of the calendar year must be considered along with any vesting that carries over from the old option to the new option. In addition, any vesting in the old option that precedes the new option grant may also have to be included.

There is also the possibility that an ISO-for-ISO option exchange program may involve a "tandem" stock option in violation of Section 422(c)(4). The IRS' position with respect to tandem stock options was intended to put an end to a perceived device used to circumvent the statutory requirements applicable to qualified stock options by granting qualified stock options in tandem with NQSOs. Rev. Rul. 73-26, 1973-1 C.B. 204 concluded that a tandem option was in substance a single option with alternative purchase terms. However, it is apparent from Rev. Rul. 73-26 and from a later Revenue Ruling, 74-606, 1974-2 C.B. 141, that tandem options are permissible if both such options qualify as statutory stock options.

In an ISO-for-ISO option exchange arrangement, both of the options presumably satisfy the statutory requirements of Section 422, thereby comporting with the congressional objective of Section 422(c)(4) and the IRS' position in Rev. Rul. 74-606. Furthermore, option exchange programs involve options that are granted independently rather than in "tandem" with other options. Accordingly, so long as the old option and the new option are both ISOs or are both NQSOs, no tandem option should result.

An exchange or repricing should not have any tax consequences for employees who hold NQSOs. Under Section 83, an NQSO is not taxable until the option is either exercised or disposed of. In an option exchange program, there surrender and cancellation of the underwater option will not trigger tax since the receipt of a new NQSO is not taxable under Section 83.

From an accounting standpoint, an option repricing or exchange program will not normally give rise to compensation expense for financial accounting purposes. However, under APB 16, if the company were to be involved in a business combination in the two-year period following an option exchange or repricing, the company would have to demonstrate that the exchange was not done in contemplation of the business combination to be able to account for the combination as a pooling.

CONCLUSION

Despite the ever-changing tax and accounting rules that apply to equity compensation, and despite the increasing participation of institutional and other shareholders in corporate governance matters, stock options and restricted stock will continue to dominate the compensation practices of emerging growth companies. If properly structured, equity can provide a tremendous incentive to employees and motivate employees to drive the future success of the company.

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