ANALYZING POTENTIAL OWNERSHIP TRANSITION OPTIONS UTILIZING DEFERRED COMPENSATION ARRANGEMENTS

by Ronald J. Adams, CPA, CVA, ABV, CBA, CFF, FVS, CGMA

Many smaller companies want to share ownership with employees but find the legal costs and complexities of various common plans daunting.

For owners wanting to sell to employees, an employee stock ownership plan (ESOP) has great tax benefits, however, the costs to implement tend to be higher compared to other alternatives, and related complexities are somewhat daunting.

For other owners who just want to share some kind of equity interest with employees, stock options, stock appreciation rights, or restricted stock may be good choices. In addition, finding an equity investor to buy-out the owner's equity interest is certainly an alternative or the sale of the company to a strategic buyer is an option as well.

Selling to Employees

The basic objective of selling to employees is to find a way that provides the owner with a reasonable value while allowing employees to purchase the company with pretax dollars. An ESOP is an ideal mechanism for this, but if it is not practical for one reason or another, there are ways to sell to employees than can meet these criteria, albeit not as effectively.

Sell Directly - the simplest model is for employees to come up with their own money to buy the company. The owner gets capital gains treatment on the sale; the employees, however, must use after-tax dollars to make the purchase.

In practice, few companies have employees capable of buying more than a minority stake with their own assets. If this is not possible, a few options can be considered:

1. The owner can take a note (installment sale): In this case, the employees come up With some cash up front and pay the rest, with interest, over time.

2. The company can loan money to employees - If there is sufficient cash, the company can make a loan to employees. If not at an arms-length rate of interest, however, the difference is taxable as current income to employees.

3. The employees could forego bonuses over some years to buy out the owner gradually.

With any of these arrangements, ownership is usually parceled out pro-rata to employees' investments. If some employees cannot afford to buy in, but the company wants them to have some ownership interest, it could allow them to take wage reductions over time or forego bonuses. The income might be used to buy newly issued shares so that the company's capitalization increases or it could be used to buy shares from the original employee group.

The seller can agree, for instance, to be paid out of the future earnings of the company, partially in return for consulting or as payments on a note. Both require ordinary income tax for the seller, however.

Purchase or Bonus?

A basic decision to be made is whether employees will receive their ownership stake by buying shares, receiving them as part of their compensation, or some combination. There are trade-offs involved with either approach. What works will depend on the desires and financial needs of the employees, the current owner, and the company, as well as how quickly all parties want to transfer ownership.

From the viewpoint of the company, it is advantageous if employees are willing and able to pay for shares (assuming securities registration can be avoided). It may be necessary for employees to put up money in order to complete a buyout, to convince lenders that employees will be committed to the employee-owned company, or because the company is not able to purchase or give away the shares. However, there has not been great success with employee ownership that relies on employees to put up their own money to buy shares. Lower and middle income employees have little extra income to spend on long-term savings of any kind, much less on risky investments in small companies.

Employees can always refuse to buy or accept stock (unless it is a mandatory condition for employment). In most cases where ownership is for sale to employees rather than given as a benefit of employment and buying stock is not mandatory, only a few highly paid employees will likely participate, if any. Also, selling stock to employees who are not experienced investors may sometimes impose a legal obligation on the company to make sure that the employee is making a prudent investment, something that is not always easy to guarantee.

Stock Options

Stock options give an employee the right to purchase shares at a price fixed today (the grant price) for a defined number of years into the future (the exercise term). Options usually are subject to vesting, so an employee might get, for instance, the right to purchase 25% of the shares available under the option grant after two years, 50% after three, 75% after four, and 100% after five. The exercise term is most commonly 10 years.

There are two kinds of options: nonqualified stock options (NSOs) and incentive stock options (ISOs). Anyone can receive an NSO; only employees are eligible for ISOs. Under an NSO, the employee can receive the right to purchase shares at any price (although some states require the price not be less than 85% of fair market value, something usually set by the board or an appraiser in closely held companies, and offerings under 85% can create tax issues). Almost always, the offering is a fair market value price. Once vested, the options can be exercised (that is, the employee can buy the shares) any time until they expire. When the employee does buy the shares, the spread between the grant and exercise price is tax deductible to the company and taxable as ordinary income to the employee.

With an ISO, when the employee exercises, if the shares are held at least one year after exercise and two years after grant, the employee does not have to pay tax until the shares are sold, and then pays capital gains taxes. The company, however, does not get a tax deduction. Employees cannot receive more than $100,000 in options that become exercisable in any one year (that is, become fully vested), must be granted options at not less than fair market value for the option (or 110% for 10% owners), and cannot hold the options more than 90 days after leaving employment. If the terms of an ISO are not met, they are treated like an NSO.

Stock Appreciations Rights ("SARs")

The company installed stock appreciation rights ("SARs") program would compensate the company's key employees for their efforts in making the company a success.

When implemented, the SARs program, would provide the right to the monetary equivalent of the increase in the value of a specified number of shares over a specific period of time to employees of a company. Participants in the SARs program will have an opportunity to exercise their share equivalents at any time according to the vesting mechanism put in place. Employees would be taxed when the right to the benefit is exercised. At that point, the value of the SARs award, minus any consideration paid for it (there usually is none) is taxed as ordinary income to the employee and is deductible to the employer for tax purposes. The company will record an employee compensation charge on its income statement for financial accounting and reporting purposes as the employee's interest in the award increases.

Once the SARs program is initiated, the company would need to obtain a formal fair market valuation of its common stock, which will allow the company, its auditors, and tax authorities to access the amount of discretionary compensation expensed by the company as the SARs continue to vest over a period of time. It is strongly advisable that the company hire a professional valuation firm that would address concerns of Internal Revenue Code Section 409A ("**IRC Section 409A**") relating to stock options and other forms of equity compensation.

IRC Section 409A can penalize discretionary deferrals of compensation under "non-qualified deferred compensation arrangements" by imposing a 20% additional tax on the recipient (as well as interest-like penalties) unless specific requirement are met. IRC Section 409A affects not only traditional deferred cash payments, but also other compensation arrangements that have a similar economic effect of deferring tax on amounts earned in one year but not paid until a subsequent year, such as stock options with in-the-money exercise prices at their date of grant.

A company should consider its SARs programs in light of IRC Section 409A. For non-statutory stock option ("NSOs") programs, most companies are taking action to ensure that all NSOs are granted with an exercise price at (or above) fair market value. In addition, some companies are now performing valuation "check-ups" for options intended to qualify as incentive stock options ("ISOs") to ensure that the underlying stock was properly valued so that the options satisfy the ISO requirement and therefore not subject to IRC Section 409A.

Beyond the additional tax that may be imposed by IRC Section 409A, valuation issues may arise in related areas. In the transactional context, privately-held companies may start to see more

detailed representations and warranties about the accuracy of their valuation methods coming from potential acquirers. Moreover, it is important for companies to adopt a reasonable valuation method to avoid potential liabilities for inaccurate tax reporting and withholding and potential lawsuits by option holders who unexpectedly face increased tax liabilities as a result of IRC Section 409A.

Restricted Stock

Companies can grant employees "restricted stock," shares that are subject to restrictions. Under these plans, an employee receives a defined number of company shares that are subject to forfeiture and transfer restrictions unless certain qualifications are met, such as the employee staying with the company for a defined number of years, the company meeting specified profit goals, or the employee meeting individual goals. While the restrictions are in place, the employee could still be eligible for any dividends paid on the shares and could be allowed to vote them as well.

Taxation of shares is complicated, and the advice of a tax attorney may need to be sought in specific cases.

However, the following rules should generally apply:

1. The taxable value of shares transferred to employees is their value minus any amount paid by the employees for the shares.

2. The company can deduct the taxable value of shares given as a benefit of employment in the year that employees claim the value of shares received as part of their income taxes.

3. If employees receive shares that they can sell, they must pay taxes in that year. If they receive shares that have restrictions on resale, however, they have two choices: either pays taxes in that year, or waits and pay taxes in the year that transfer restrictions expire.

4. If the shares are restricted shares and the restrictions create a "significant risk of forfeiture" because the conditions may not be met, then the employee has a choice about taxes. He or she can file an "83(b) election" and choose to pay ordinary income tax on the gift value of the shares (their value minus any amount paid for them) at the time the award is made. Once the shares are received, the employee would then pay no tax until they were sold, and then would pay capital gains tax on the difference between the value declared for the 83(b) election and the sale price. If the employee fails to meet the conditions, however, and receives no shares, the tax cannot be recaptured.

   If the employee does not file this election, then when the shares are received (not sold) the employee pays ordinary income tax on their value minus any consideration paid for them.

These tax obligations must be considered carefully. Being able to deduct the cost of shares substantially reduces the cost of direct employee ownership for the company. On the other hand, few employees will be able to or want to cover the cost of taxes on shares for which they may receive no financial benefits for many years.

As for cost, direct ownership usually requires less specialized legal services than other employee ownership options. A typical set-up cost is $3,000-$5,000. With thorough preparation this cost may be much less. In general, the simpler the share arrangement, the cheaper it will be to set up.

Finding an Equity Investor

Another alternative would be to find a strategic equity investor who is willing to invest a substantial amount of capital and purchase the owner's shares of stock.

Sale of the Company

Lastly, another option to consider is the outright sale of the company to a strategic buyer.

Establishing Reasonable Valuations under Internal Revenue Code Section 409A (IRC Section 409A)

Publicly-traded companies' stock trading price generally provides a reliable measure of stock value so that public companies can confidently conclude that the exercise price on a granted option will be not less than the fair market value of stock to which an option relates. However, for companies whose stock is not readily tradable in an established securities market, the IRC Section 409A fair market value determination is more complex.

Regulations under IRC Section 409A identify the key factors that the Internal Revenue Service (IRS) will use to assess the reasonableness of a proposed valuation method. The proposed regulations also provide three presumptively-reasonable valuation approaches that companies whose stock is not readily tradable in an established market can use.

The regulations require the employer or other service recipient to use a "reasonable valuation method" to determine the value of stock underlying compensatory option grants. The reasonableness of any proposed valuation method will be based on the relevant facts and circumstances as of a specified valuation date. The IRS will consider the following factors to test the reasonableness of a proposed valuation method:

- The value of the company's tangible and intangible assets;
- The present value of the company's future cash flows;
- The market value of stock or equity interests in substantially similar businesses that can be determined readily by objective means;
- The effects of any control premiums and/or marketability discounts;

- Whether the proposed valuation method is used for other material purposes by the company, its stockholders, or creditors; and
- Other relevant factors.

The IRS will *not* consider a valuation method to be reasonable if it fails to take into account all information that is material to the company's valuation. In addition, a value that was previously determined under an otherwise-reasonable method will not be considered to be reasonable for purposes of ITC Section 409A if *either* the determined value does not reflect after-acquired information with material effects on the company's current value or the value was determined as of a date more than 12 months before the date for which the valuation is being used. It is more likely that the IRS will accept the reasonableness of a valuation method if the same method is used for purposes unrelated to the compensation of employees or other "service providers."

Further Questions:

If you have additional questions or wish to discuss this topic further, you can contact: Ronald J. Adams, CPA, CVA, ABV, CBA, CFF, FVS, CGMA, Managing Director – Valuations, at (774) 719-2236 – office; or at (508) 878-8390 – mobile; or e-mail him at: **adams.r@foxboro-consulting.com** .

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