The Basics Behind the Beans:
An Intro to Equity Comp Tax and Accounting

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Agenda

- Introduction – Why is this important?
- Taxation of stock compensation
- Accounting for stock compensation
Introduction

- Why is this important?
  - Significant fines/corporate and personal liability
    - SEC filings – 10-Q, 10-K, CFO certification
    - IRS fines
      - Payroll taxes
      - Individuals overpaying taxes
Introduction

Why is this important?

- Most people hear terms but are afraid to ask why or understand the basic theory.
  - Why are options considered an expense before exercise?
  - What are the two tax transactions that occur for each cashless exercise?
- Without a firm basic foundation you will never properly understand or anticipate more complex issues and could make critical mistakes
- Don’t trust your finance or tax team to know – in many cases they are not experienced with the nuances of equity compensation
- Objective is to sensitize you to the issues you may encounter. You will have to do more research to learn about what the implications are.
Follow-up steps for more knowledge

- Obtain your CEP
- Read (books published by the NCEO):
  - The Stock Options Book
  - Equity Alternatives
  - Accounting for Stock Compensation
- NASPP Resources
  - NASPP University online programs
  - NASPP website
Taxation of Stock Compensation

Where do tax laws come from?

- Congress
  - Tax Code

- IRS
  - Tax regulations
  - Revenue Rulings
  - Revenue Procedures
  - Private Letter Rulings
  - Memorandums
  - Forms and Instructions
  - Publications

The IRS does not create tax law; they merely interpret the law.
Taxation of Stock Compensation

- **When is tax due?**
  - Non-qualified arrangements
    - Non-qualified stock options (NQSOs) and stock appreciation rights (SARs)
    - Tax due at exercise date

- **Why is tax due at that time?**
  - Exercise = decision to purchase stock
  - Stock is acquired at a discount
  - The discount is a compensation benefit
  - This benefit results in taxable income
Taxation of Stock Compensation

• **When is tax due?**
  - Restricted stock arrangements
    - Restricted stock (time and performance-vested)
      - No Section 83(b) election: Subject to tax at **vest**
      - Section 83(b) election: Subject to tax at grant
    - Restricted units (time and performance-vested)
      - Subject to tax at payout
        - FICA due when forfeiture restrictions lapse

• **Why is tax due at that time?**
  - Vesting/delivery = receipt of stock with value
  - The value received is a compensation benefit
  - This benefit results in taxable income
Taxation of Stock Compensation

When is tax due?

- Tax qualified arrangements
  - Incentive stock options (ISOs)
    Subject to tax at **sale**
    W-2 reporting for **disqualifying** sales
    - Exception: Cash exercise of ISOs & shares held through year-end
    - Spread subject to AMT at exercise
    - Employee stock purchase plans (Section 423 qualified)
  - Employee stock purchase plans (ESPPs)
    Subject to tax at **sale**
    W-2 reporting for almost all sales
  - Both ISOs and ESPPs
    No payroll withholding
    (But estimated tax may be due)
    No FICA withholding (ever)
Taxation of Stock Compensation

**How much income is taxed?**
- **Non-qualified arrangements**
  - Spread (FMV less amount paid for the stock, if any) at the time of:
    - Exercise: Options, SARs
    - Vesting: Restricted stock
    - Stock Delivery: RSUs
  - Payroll withholding always applies
- **Qualified arrangements**
  - Depends on whether the sale meets the statutory holding periods
  - No payroll withholding applies
  - *ISO rules differ from ESPP rules*
Taxation of Stock Compensation

- What is the company’s responsibility?
  - Non-qualified arrangements
    - Employees/Former Employees: Report compensation income and withhold taxes (W-2)
    - Non-Employees: Report compensation income (1099-MISC)
    - Tax deduction
  - Qualified arrangements (ISOs and ESPPs)
    - Report compensation income (W-2)
    - Report transactions to IRS (includes 3921/3922)
    - Tax deduction for sales that don’t meet the required holding period
    - Exempt from tax withholding
Tax Reporting

• What is the company’s responsibility?

• Section 6039
  • ISO exercises reported on Form 3921
  • ESPP transactions reported on Form 3922

  Upon purchase, if shares are immediately deposited into employee’s account at captive/designated broker

  Upon first transfer of legal title, if shares are certificated or held in book entry, or held at non-company broker
Tax Withholding

- At what rates are payroll taxes withheld?
  - Stock compensation is considered a supplemental payment
    - Federal income tax is withheld at W-4 rate or flat rate (currently 25%)
      39.6% for individuals that have received more than $1 million in supplemental payments
  - FICA
    Social Security rate is 6.2% for 2014 on wages up to $118,500
    Medicare withholding rate is 1.45% and increases to 2.35% for wages in excess $200,000
    Company must make matching FICA payments
  - Medicare increase applies only to the employee portion
  - FUTA
    Company must make any required FUTA payments, up to annual maximum
  - State and local tax withholding may also apply
Tax Withholding

What is the broker’s responsibility?

- Facility to sell shares and monetize awards
- Control regulatory requirements (Sec. 16, 144)
- Backup withholding
- 1099-B proceeds and cost basis reporting
- Pay/reinvest dividends
  - NRA withholding
  - 1099-DIV/1042-S
Tax Withholding

What is the participant’s responsibility?

- Monitor W-4 exemptions and withholding
- Possible estimated tax payments (qualified awards)
- Proper tax reporting
  - Calculating correct cost basis
  - Form 8949/Schedule D (capital gain/loss reporting)
Additional Considerations

- $100K in payroll deposits due next day

- Exercises that bridge earnings limits
  - $1 million Federal
  - $118,500 Social Security
  - $200,000 Medicare

- Life events
  - Death
  - Divorce
  - Transfers

- Dividends
Tax Section Q&A
Financial Accounting

- Where do accounting standards come from?

SEC
Financial statements should be:
  - Complete
  - Consistent
  - Accurate

IASB
- International Financial Reporting Standards

FASB
- Account Standards Codification
- Emerging Issues Task Force
- Staff Technical Bulletins

US GAAP
# The Income Statement

**Revenue**
- **Sales Revenue**: $2,000,000
- **Service Revenue**: $1,000,000
- **Total Revenue**: $3,000,000

**Expenses**
- **Cost of Goods Sold**: $1,500,000
- **Compensation Expense**: $500,000
- **Depreciation Expense**: $175,000
- **Warranty Expense**: $200,000
- **General Expense**: $125,000
- **Total Expenses**: ($2,500,000)

**Net Income**: $500,000

Expenses: Salary, bonuses, benefits, and stock plans!
Accounting for Stock Compensation

**What is expensed?**

- Stock plans can be compensatory vs. non-compensatory
  - Compensatory plans result in an income statement expense, non-compensatory plans do not
  - Most forms of stock compensation are compensatory
    - Stock options and appreciation rights
    - Restricted stock/units
    - Most section 423 ESPPs (>5% discount or a lookback)
Accounting for Stock Compensation

How is expense determined?

ASC 718 uses a “fair value” approach to valuing share-based payments.

- Fair value is the amount an investor would be willing to pay for the grant.
  
  Restricted stock and units: Generally equal to FMV of stock (less any amount paid by employee).

Stock options, SARs, ESPPs:

- Trading prices of similar arrangements.
- If no similar arrangements are traded, estimated using an option pricing model.

\[
C = SD^{-t}N(x) - Kr^{-t}N(x - \sigma\sqrt{t})
\]

\[
x = \frac{\ln\left(\frac{SD^{-t}}{Kr^{-t}}\right)}{s\sqrt{t}} + \frac{s\sqrt{t}}{2}
\]
Accounting for Stock Compensation

- **How is expense determined?**
  - Option pricing model
    - Must incorporate the following assumptions:
      - Exercise price
      - Fair market value of the underlying stock
      - Expected life of the option (the length of time the option is expected to be outstanding)
      - Expected volatility of the underlying stock
      - Expected dividend yield for the underlying stock
      - Risk free interest rate for the option’s expected life
Accounting for Stock Compensation

- When is expense determined?
  - Measurement date*
    - Date on which expense is calculated for the grant
    - Grant date
    - Exercise date

* For arrangements that are settled in stock and granted to employees.
Accounting for Stock Compensation

- When is expense recognized?
  - Expense is recorded over the service period of the grant
  - When the employee performs services to earn the award (matching principle)
  - Typically the vesting period (explicit service period)
Accounting for Stock Compensation

- **When is expense adjusted?**
  - Service/non-market performance conditions
    - No expense recognized for grants that are forfeited prior to vesting
    - Expense is reduced for estimated forfeitures and trued up to actual outcome
  - Market conditions
    - Initial fair value considers likelihood of forfeiture, so no adjustment when forfeiture occurs

*Expense is not adjusted for options that vest but expire unexercised.*
Accounting for Stock Compensation

- When is expense adjusted?
  - Amendment/modification of awards
    - Changes to vesting conditions or period
    - Changes to post-termination exercise period
    - Repricing/option exchange programs
    - Change in control of company - acceleration
What is paid-in-capital?

Balance sheet reports a company’s financial position:
- Assets
- Liabilities
- Stockholders’ Equity

Paid-in-capital is a stockholders’ equity account representing funds received in excess of par value for stock.

Balance Sheet

Stockholders’ Equity

Preferred stock (Authorized: 200,000 shares, Issued and outstanding: none) --

Common stock ($0.01 par value, Authorized: 10,000,000 shares, Issued and outstanding: 1,000,000 shares) $ 10,000

Additional paid-in-capital 6,000,000

Retained Earnings 1,000,000

Treasury Stock (50,000 shares) (800,000)

Total Stockholders’ Equity: $ 6,210,000
Example – Tax Effects

Assume that the company recorded earnings of $1,000,000 before recognizing any expense for its stock plans.

NQSO fair value: $50,000
Corp tax rate: 40%

<table>
<thead>
<tr>
<th></th>
<th>Income Statement</th>
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<tbody>
<tr>
<td></td>
<td>Before</td>
</tr>
<tr>
<td></td>
<td>Option</td>
</tr>
<tr>
<td>Pre-Tax Earnings:</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Tax Expense:</td>
<td>$400,000</td>
</tr>
<tr>
<td>Net Earnings:</td>
<td>$600,000</td>
</tr>
</tbody>
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Example – Tax Effects

- **Possible outcomes**
  - Option is exercised at a gain of $70,000
    - $20,000 more than expense recognized for the option, so the company records $8,000 of additional paid-in-capital
      
      Actual tax savings is $28,000 ($70,000 x 40%)
      
      $8,000 more than reported tax savings of $20,000
  
  - Option is exercised at a gain of $40,000
    - $10,000 less than expense recognized, so the company deducts $4,000 from paid-in-capital (or records this as tax expense, if there isn’t enough paid-in-capital from prior stock plan transactions)
      
      Actual tax savings is $16,000 ($40,000 x 40%)
      
      $4,000 less than reported tax savings of $20,000
Introduction

• Why aren’t tax rules and accounting rules the same?
  – Investors want to know how much a company made
  – FASB wants companies to:
    • Recognize employee benefits as they are earned
    • Properly estimate benefits company will receive (tax savings)
  – Accrual accounting
  – Taxation relates to the effects on the individual participant
  – No taxation until value received without restriction
  – Influencing behavior through qualified awards
    • Long-term ownership
    • Align company success with personal investment
Additional Accounting Considerations

- **Restricted stock/units**
  - Same as options, except that fair value is generally FMV at grant

- **SARs**
  - Same as options, if paid out in stock
  - Cash payout triggers liability treatment

- **Performance awards (non-market)**
  - Forfeiture estimates should consider targets

- **Performance awards (market)**
  - Monte Carlo simulation
  - No reversal of expense for forfeitures
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