Making Sense of Stock-Based Compensation for Your Tax Provision

Corporations love stock-based comp. It costs nothing to offer, it aligns them with the interests of the talent they most need, and it can generate significant tax deductions. But reconciling the accounting and tax aspects of stock-based comp with the tax provision calculation can be tricky. Here's how to streamline the process.

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For ambitious companies—from startups to the 800-lb tech-heavy gorillas that roam the earth—the benefits of stock-based compensation seem almost too good to be true. Not only do these plans enable you to compensate employees without laying out cash—preserving that fuel for investments in growth, while portraying the company's financial health in the very best light—they're also a wonderful way to align your energies and ambitions with those of your employees.

Stock options help preserve employee cash as well, by affording them equity participation without risking any investment capital. Essentially, they reward employees with *future* value for the work they're doing *today*—while binding them to the organization for a defined "vesting" period.

Stock-based compensation can have a **material impact** on your effective tax rate.

That's great for the balance sheet, great for the company (despite the dilutive effect of offering the extra stock), and great for the employee. But from a tax-planning point of view, what's most noteworthy about stock-based comp is that it can generate substantial tax deductions—thus lowering your effective tax rate (ETR). Further, this non-cash expense can lead to significant cash tax savings. In fact, when it comes to the book-to-tax calculations that are at the heart of the tax provision process, stock options and other forms of equity compensation often have enormous, material impact on both the ETR and the current provision (or estimate of tax due for the year).

So, while equity-based compensation plans clearly have value, the question is: how do you account for it—and how does that value affect the all-important tax provision calculation? That's precisely what we'll be tackling here.

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Under US GAAP, accurate financial reporting requires companies to record expenses for the period of time they're used. Accounting Standards Codification Topic 718 (ASC 718)—which governs how companies must report compensation expense for equity instruments—specifies that they should be valued as of their grant date, and that a portion of their expected value at exercise should be expensed annually over the instrument's vesting period.

The problem is that while vesting represents a noncash expense that reduces book income, it's not recognized by the Internal Revenue Code as an ongoing deductible expense. That leads to the kind of book-to-tax differences that are among the trickiest aspects of the tax-provision process—the kinds that can raise red flags and material issues under audit.

It's Good to Have Options… Especially (Nonqualified) Stock Options

From a tax provision point of view, it's useful to break stock-based comp plans into two categories: those which *allow* for company deductions and are treated as temporary adjustments—and those which are *not* deductible to the company and are therefore treated as permanent adjustments.

In the temporary adjustment category is the garden-variety **nonqualified stock option** (NQSO). The company grants the employee (or anyone, really—directors, consultants, suppliers, etc.) the right, but not the obligation, to buy a specific amount of shares at a specific price—after a set vesting period, and before a certain expiration date. For financial accounting purposes, the company records a portion of the expected final value of the option as a compensation book expense, annually, over that entire period.

Now, the timing issue: As a company, you know you're going to *eventually* get the deduction when the employee picks up the income (assuming they ever do)—but even though that amortized expense is rolling through your books year after year, the tax authorities won't let you deduct it until those options are actually exercised. So how do you account for that future tax benefit in the meantime? And then, once you do recognize it, how do you account for any excess benefit (or shortfall) between the estimate you made and whatever the tax impact ends up being?

It can be helpful to look at the journey as a three-step process:

Step One:
Calculate and record the theoretical future market value—or "fair value"—of the shares you're granting to the recipient *once they are vested*. (Since accountants are lousy fortune-tellers, that requires some advanced calculus using option-pricing models such as Black-Scholes.) Then, extend that imaginary measuring stick back to the present—to the "exercise price," or the market value of the shares on the day when the options were granted. The financial distance between those two markers, from date of grant to date of exercise, is considered the "spread" of the options—that's the number both accountants and tax professionals will work with, on separate paths.

Step Two:
For the financial accounting team, the process is straightforward to the point of being mechanical: Divide the amount over the number of years in the vesting period, then let that number flow through the books until the recipient exercises the options. For the tax team, it's a bit trickier. In parallel, under GAAP, you'll record an increase to your *deferred tax asset* each year to account for the book expense recorded, that is currently non-deductible for tax purposes, and you'll have a temporary difference running through your current provision increasing the current year's taxable income from the financial income starting point that includes the unexercised stock compensation expense.

Step Three:
The shares are vested and the employee exercises the option (presumably, the current share price is significantly greater than the original exercise price, or why bother?). The employee records the spread as personal income, which is taxed as ordinary income (note that some companies require recipients to hold on to those shares even after they've exercised them—in that case, any subsequent gain or loss is treated like any other investment, under the applicable capital gain and holding period rules). The company receives a deduction for the spread, the deferred tax asset is reversed, and any excess or shortfall is recorded as a permanent item.

The showstopper for your tax provision here is that any excess tax benefit realized in this way becomes a *rate driver*: a material item that can lower your effective tax rate. In fact, it's one of the reasons why some of the biggest names in tech, loaded with employees holding stock options or restricted stock, have such low ETRs.

While all parties theoretically benefit from nonqualified stock options, those benefits are somewhat lopsided. The recipient realizes the value of the stock exercise, sure. But as noted, they must pay ordinary income tax rates on the spread once exercised (even if they don't sell their shares). The company, on the other hand, gets a huge, triple benefit: not only does it get the full deduction and lower ETR, but because those stock options are considered noncash, they get to show higher profits and steady cash flow on the financial statement.

Nonqualified stock options are tailwinds in a good year—and headwinds in a down year.

Naturally, there's a downside—and it's one we may experience in a downturn. If the company's not having a good year and the stock price takes a dive, employees will be less likely to exercise their options, and companies will be less likely to see that excess tax benefit, and therefore, lower ETR. In practical terms, these schemes act as tailwinds for companies that are already having a good year—but headwinds for companies whose stock prices are on the downswing.

Incentive Stock Options: Tax-Advantageous… to a Select Few

In terms of non-deductible stock options, we find a more rarefied breed: the **incentive stock option** (ISO), eligible only for special employees. As with the nonqualified stock option, the company grants the employee the option to purchase a certain number of shares of stock, at the exercise price, after a vesting date, and usually subject to a condition of continued employment. But unlike NQSOs, there are many additional tax advantages to the recipient—and many statutory requirements to qualify for the preferential treatment.

ISOs allow the employee to, first, *defer taxation on the option* from the date of the exercise until the date of the actual sale of the underlying shares; and second, to pay tax on the deferred gain at the generous long-term capital gains rate (which presently tops off at 20%)—a fraction of the ordinary income tax rate. A pretty sweet deal (if you can steer clear of the alternative minimum tax).

For the company, the accounting and tax provision treatment of ISOs is straightforward: Once again, the company calculates the fair value of the options on the grant date using an options-pricing model. It records the value as compensation expense over the vesting period. *But* since the employee doesn't pay ordinary income tax upon exercise, the company doesn't get a deduction—and it doesn't record a deferred tax asset. The compensation expense is treated as a permanent add-back. The book expense is disallowed—which effectively increases the ETR. (If the employee doesn't meet the required holding period, they are required to pay ordinary income tax on the spread, and the company does get to deduct that amount.)

There are all kinds of business reasons for offering ISOs...but from a strictly tax perspective, all the benefit of these options go to the recipient, not the company.

There are all kinds of business reasons for offering ISOs—especially during a company's infancy when a key person is needed and/or the short-term benefits are deemed to outweigh any future costs—but from a strictly tax perspective, *all* the benefit of these options go to the recipient, not the company.

Restricted Stock Units (RSUs): A Sweeter Carrot, but a Sharper Stick

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Like NQSOs, RSUs allow for company deductions, are treated as temporary adjustments, and can be offered to both employees and non-employees. But unlike with the typical stock option, recipients aren't automatically granted the option to buy shares—they're only granted "units," or *the right* to purchase shares at fair market value (or at a discount, or at no cost, as a form of compensation) upon vesting. The catch is, they don't get those shares until a specific "restrictive condition" has been met. (If they leave before then, they forfeit the potential benefit.)

And what are those restrictions? The company could, for instance, require continuous service from the employee over a vesting period (a restriction which may lapse on a specific date, or may gradually disappear based on time served). The award could be predicated on hitting a target stock price, or on some other performance milestone.

Restricted stock accounting has some similarities to ordinary stock option accounting—with a few wrinkles based on the nature of those restrictions. The company records the value of the award as of the grant date as a noncash compensation expense, stretched out over the vesting period. In parallel, it recognizes a deferred tax asset in anticipation of the future deduction. When the award vests, the shares are distributed, and the employee is taxed on their entire value as ordinary income. The company receives a tax deduction equal to that amount, the deferred tax asset gets reversed—and any excess benefit is treated as a permanent adjustment, lowering the company's ETR.

Now, for those wrinkles: If the only restriction is a time-based vesting, then the company accounts for the restricted stock by determining the total compensation cost *at the time of the grant*—no fancy option-pricing model is needed, since only "units," not shares, were granted at the start. If the employee simply buys the shares at current market value, no charge is recorded. But if the employee receives a discount on the share price (or is awarded the shares for free), then that discount (or value) must be recorded as a cost—and it gets amortized over the vesting period, until the restriction lapses.

If the restriction is based on a performance milestone like stock price, the company must estimate how long it will take to meet that goal using an option-pricing model, and then recognize the expense over this expected vesting period.

Phantom Stock and Stock Appreciation Rights: A Bonus by Another Name

Phantom stock and **stock appreciation rights** are essentially promises to pay employees cash bonuses for a stated number of the company's shares, at the end of a specified period of time. The key difference is that phantom stock is based on the *value* of the shares over that period, whereas stock appreciation rights are based on an *increase in the value* of those shares over the period.

Phantom stock and cash-settled stock appreciation rights are subject to *liability accounting*, meaning the accounting costs associated with them aren't settled until they pay out or expire. In both cases, employees are taxed (as ordinary income) when they exercise the right to the benefit, with a corresponding tax deduction for the company. For cash-settled stock appreciation rights, the compensation expense for awards is estimated each quarter using an option-pricing model, then trued-up when the rights are settled. For cash-settled phantom stock, the underlying value is calculated each quarter and trued-up through the final settlement date—essentially, it is treated the same way as deferred cash compensation.

If the company offers stock instead of cash, the accounting is identical to that of a stock option: it must record the fair market value at grant and recognize the expense over the expected service period of the rights. If the award is conditioned on performance-vesting, then the company must estimate how long it will take to meet the goal. If the measurement is tied to the company's stock price, it must use an option-pricing model to determine when and if the goal will be met.

Employee Stock Ownership (or Purchase) Plans (ESOPs)… Are You Qualified?

ESOPs are designed to keep participating employees focused on the company's share price appreciation and corporate performance. The plans allow employees to set aside money from their taxable payroll deductions, to purchase stock at the end of a so-called "offering period." The company maintains the ESOP shares in a trust for the benefit of the employees. The appreciation of the shares accrues to the employee until the employee retires or resigns.

Plans can either be "qualified" under Section 423 of the Internal Revenue Code, or unqualified. In the former case, they resemble **incentive stock options**. They can be offered to employees with no upfront costs. And, when they sell their shares, the employee may receive capital gains treatment on any gains from stock acquired under the plan. And, just like the ISO, the company may not obtain a tax deduction. The compensation expense is treated as a permanent adjustment, and increases the ETR.

If the ESOP is a non-qualified plan, for tax accounting purposes, they would be treated like an **NQSO**: the compensation is temporarily subtracted over the vesting period as a deferred tax asset, while the excess tax benefit is considered a permanent adjustment—lowering the ETR.

The "Open-Options" Exercise

Tracking options can be a nightmare for tax and accounting teams. Running an open-options exercise can help.

This practical tool will yield the ending value of your deferred tax assets, based on all the book expenses to date, minus any tax deduction up to that amount.

Best of all, it allows you to confirm to your auditor that all your outstanding options have been accounted for—and that your deferred tax schedule is correct.

"Exercise" Care: Material Errors Are Not an Option

Equity-based compensation is a powerful tool for recruiting, rewarding, and retaining the people you need to help advance the success of your enterprise. No matter how exotic the plan, or complicated the accounting, fundamentally, stock options, restricted stock, and the other plans outlined here are simply a form of compensation—a transfer of value from the current equity owners (the company) to employees, which must be captured accurately.

For the tax team, these plans also present the potential benefit of driving down your effective tax rate. That said, the inherent complexities and risks mean provision experts must exercise great care in applying the right tax treatment for the right form of stock-based compensation. Making a material error is simply not an option.

The Intelligent Approach to Tax

Yesterday's compliance approaches are no match for today's increasingly complex, dynamic regulatory environment. CrossBorder's tax compliance solutions deliver unmatched total value with modern, intelligent technology that minimizes risk, reduces or eliminates manual, error-prone processes for greater accuracy, and enables our customers to strengthen their tax position with valuable insights and forecasting. Our solutions come with flexible support options, transparent, competitive pricing and free audit support. Visit xbs.ai for more information.

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