

CORPORATE QUANDARIES – How Does One Value Employee Equity?

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Yes, a company can do either of those things. However, because of often-overlooked tax consequences, your new executive or employee is going to end up unhappy and will probably blame you, which is a less than ideal way to (literally and figuratively) invest in human capital.

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As business lawyers, we frequently get questions from our clients about types of equity incentives and valuing equity: Can an employee have options granted at \$0.01? Can we give “free” stock to a new executive? The short answer is that yes, a company can do either of those things. However, because of often-overlooked tax consequences, your new executive or employee is going to end up unhappy and will probably blame you, which is a less than ideal way to (literally and figuratively) invest in human capital.

Companies often mean well but get the wrong advice. While trying to give an employee an extra incentive by lowering the cost of new stock (by granting it outright rather than having the employee buy it) or by reducing the strike price, you will instead end up giving the employee a tax bill from the IRS. In our line of work, we call that a major dis-incentive.

To illustrate what happens, let’s compare equity compensation to cash. If you give an employee a \$20 bonus, that’s income. Now, let’s imagine you grant the employee a share of stock worth \$20, even if it’s subject to vesting. The IRS sees these two scenarios as equals and sees “here’s something worth \$20” as the equivalent of “here’s \$20” and taxes it accordingly. So granting (giving) equity is taxed the same as giving cash. (To avoid this issue, in most scenarios we recommend the use of options instead of equity grants. In fact, this “pay taxes in cash today on non-cash ‘paper income’” problem is why option grants exist.)

Similarly, if you sell property to an employee at less than its value, the IRS sees also income, which shows us the path out of this employee tax mess. For example, if you sell the employee a \$20 bill for \$10, the IRS sees \$10 of income and will levy tax. But what if you just give the employee the right to buy a \$20 bill for \$10? That \$10 “discount” on the \$20 value is treated as by the IRS as \$10 of current income recognized *at the time of the grant of the right*.

The same analysis applies to a share of stock (or unit of an LLC). If you give the employee the right to buy for \$5 a share that is “worth” \$20, the IRS sees \$15 of taxable income at the time of the original grant. That is THE major reason why granting options below FMV is virtually never done: it creates very unpleasant tax consequences.

To illustrate – as a company, you want to entice a new CFO to come on board and to do so, you grant her 100,000 options at \$0.01 when the FMV is \$1.00. On paper this seems extremely generous but quickly leads to a tax catastrophe. Without any regard to vesting, without regard for the fact that the option hasn’t been exercised, without regard for the fact that the option securities haven’t been sold, and without regard for the possibility that the FMV might go down in the future, the IRS will see \$99,000 of taxable income at that time and require your employee to write them a check for about \$30,000 - \$40,000 of real money to pay taxes on the paper profits. Let us give you a #protip here: employees **really** hate that.

To avoid this issue, we regularly advise people to issue options at fair market value. At grant, if the price of the option is the same as the FMV of the stock (you have a 5 year right to buy that \$20 bill for \$20), the IRS sees no gain (for the typical small company; large public companies end up different because of complicated Nobel Prize math – we’re going to skip that topic). The IRS evaluates the present right at \$0 and an employee can typically avoid taxes until the option grant is exercised.

To address equity choice as well as all other business-related legal questions (corporate, employment, litigation, M&A, data privacy), please contact Christian Jensen, Esq. or Rick Colosimo, Esq. at OlenderFeldman LLP – (908) 964-2485; cjensen@olenderfeldman.com; rcolosimo@olenderfeldman.com.

This post was originally published at [insert Olenderfeldman.com permalink].