



Benefits Guidance Report

The FRS Benefits Guidance Report offers a review of U.S. taxation and accounting implications for equity-based compensation. We provide valuable information regarding considerations that must be addressed when offering your employees compensation in the form of equity, or when changing the current structure of existing equity compensation plans.

A team of FRS Equity Strategies, Inc. top-level certified equity compensation experts compiled the information presented in this report. The report is intended for general purposes, and is not an exhaustive discussion of all laws and regulations affecting equity compensation. The report addresses common issues and provides a general outline of some of the tax and accounting considerations when designing or modifying an incentive plan. The information also serves as a useful tool for reviewing the general compliance issues under IRS, FASB and SEC regulations covering equity compensation.

We present the accounting and taxation considerations for each of the following types of equity:

- I. **Incentive Stock Options (ISOs)** – Stock Options give employees the right to buy a number of shares at a price fixed at grant for a defined number of years into the future. An ISO receives special tax treatment which we describe in detail later in the report.
- II. **Non-Qualified Stock Options (NQSOs)** – These are stock options without the special tax treatment applied to ISOs.
- III. **Restricted Stock Awards (RSAs)** – These provide employees the right to acquire or receive shares once certain restrictions are met. The employee may have voting rights on the shares during the period the restrictions are in place. Restrictions may be time-based, performance-based or a combination of the two.
- IV. **Restricted Stock Units (RSUs)** – Restricted stock units are similar to RSAs with the exception that shares are not awarded or issued at the date of grant. Units are issued at grant with the actual shares underlying the units issued when the restrictions are met. There are notable tax implications and administration considerations associated with this difference.
- V. **Stock Appreciation Rights (SARs)**, both stock-settled and cash-settled – Cash-settled stock appreciation rights provide a cash payment based upon the appreciation in stock price from the date of grant to the completion of vesting. Stock-settled stock appreciation rights function in the same way, with the payment of appreciation made in stock.
- VI. **Performance Options and Awards** – These may be either options or restricted stock shares/units. Performance-based grants tie performance achievement to the earning of the equity award. Performance may be used to determine the number of options/shares/units to be granted or it may be used to determine the vesting or removal of restrictions on the award.

Of course the considerations should not end with accounting and taxation concerns. Whenever you offer employees equity compensation you should always keep the following in mind.

- Does our equity compensation program fit with our corporate culture?
- Is the equity compensation plan designed to motivate our employees towards exceptional performance?
- Do vesting provisions and other plan design characteristics encourage the retention of key talent?
- Is our program competitive and does it attract new hires and prospective employees?

Benefits Guidance Report

I. Incentive Stock Option (ISO)

Taxation Considerations¹

- 1) No taxation to employee at time of exercise
 - a. Employee will assume tax liability at time of sale.
 - i. “Pro” is that employee’s taxation is delayed/deferred.
 - ii. “Con” is that employee must pay possible AMT, a difficult part of tax law to understand.
- 2) Generally, no required tax withholding at exercise.
 - b. Some states, such as Pennsylvania, now require state income tax withholding as they contend that State law overrides Federal law. Several companies are seeking guidance from IRS.
- 3) No company tax deduction at time of exercise; tax deduction only realized if shares are sold as a disqualifying disposition.
 - c. “Pro” is that most exercise transactions (90% in a recent survey) are Same-Day Sales and the shares are disqualified at time of exercise. The disqualification allows the company to receive a corporate tax deduction on this employee compensation at the time of exercise/sale.
- 4) ISO Grants are subject to the IRS \$100,000 limit rule. ISOs granted in excess of this rule should be treated as Non-qualified stock options.
- 5) The corporate tax benefit is realized at time of sale if the shares are sold and disqualified.
- 6) The corporate tax benefit is realized when the actual tax benefit is greater than the tax expense.
- 7) ISOs are generally deductible under Section 162(m) as the “performance-based” criteria for exemption under Sec 162(m) is typically already in place at the time of grant for this type of option. The plan must state that the shares granted under the plan are “performance-based” per the IR Code (not to be confused with performance awards that are based on meeting goals).
- 8) Not subject to 409A considerations.

Administration Considerations

- 1) ISOs can only be granted to employees and may only be granted from a plan within 10 years after the plan is adopted.
- 2) The option strike price must be at least grant date Fair Market Value (FMV). For an employee who owns 10% or more of the company stock at the time of an ISO grant, the option price must be at least 110% of the grant date FMV.
- 3) Grant cannot expire more than 10 years from grant date. For an employee who owns 10% or more of the company stock at the time of an ISO grant, the option expiration date must be no more than 5 years from grant date.
- 4) Except in cases of death and disability, ISOs must be exercised no later than 3 months after termination of employment.

Accounting Considerations

- 1) For accounting purposes, ISOs are fair-valued at grant date; no possibility for liability accounting or unknown expense.
- 2) Expense is recognized over the service period.
- 3) Under FAS123R-2, grant date is determined as the date where the company has communicated key terms and conditions (grant date, price, # shares, expiration date, etc.) within a “reasonable” timeframe
- 4) FAS123R requires companies to apply a forfeiture rate to the expense for stock options (could be historical, implied or a blended rate forecasting potential forfeitures).
- 5) Each period also requires a “true-up” on the forfeitures (what was applied as an expected forfeiture and what actually was forfeited).

¹ Applies to US tax consequences only – please consult your global tax compliance expert for specifics on a country-by-country basis.

Benefits Guidance Report

II. Non-Qualified Stock Option (NQSO)

Taxation Considerations²

- 1) Taxation and withholding is applicable at time of exercise, regardless of whether the employee sells the shares or retains ownership by holding the stock after exercise has occurred.
- 2) The company may take a deduction for the amount of ordinary income incurred as long as the income is reported appropriately.
- 3) Tax benefit is realized at time of exercise, regardless of the final disposition of the shares.
- 4) Tax benefit is realized when the actual tax benefit is greater than the tax expense.
- 5) Generally NQSOs are not subject to Section 409A if all of the following 3 conditions are met.
 - a. Option price is at or above Fair Market Value (FMV) on the date of grant.
 - b. The option is subject to IRC §83 (most compensatory options inherently do meet this requirement).
 - c. Option Agreement does not provide optionee ability to defer income.
- 6) Discounted NQSOs generally require smaller grants to attain the same grant value as one priced at FMV. However, discounted options have the following considerations:
 - a. Generally, tax penalties under Section 409A will apply.
 - b. Not deductible under Section 162(m) of IRC.
 - c. Generally not favorable with institutional investors.
- 7) For discounted options issued and vested as of or before December 31, 2004, that have the gain deferral feature built into the grant, that feature can live on and avoid the 409A trigger as those options are grandfathered into the legislation.

Accounting Considerations

- 1) For accounting purposes, stock-based compensation is fair-valued at measurement date / grant date for fixed-plan options.
 - a. Liability accounting may be imposed if options are not fixed-plan accounting.
 - b. Mark-to-market may be required.
 - c. Expense is recognized over the service period.
- 2) Under FAS123R-2, grant date is determined as the date where the company has communicated key terms and conditions (grant date, price, # shares, expiration date, etc.) within a “reasonable” timeframe.
- 3) FAS123R requires forfeiture rate to be applied and forfeiture “true-up” at each reporting period.

² Applies to US tax consequences only – please consult your global tax compliance expert for specifics on a country-by-country basis.

Benefits Guidance Report

III. Restricted Stock Award (RSA)

Taxation Considerations³

- 1) Tax due at time of vest (taxable spread or gain is determined as of the date of vest).
 - a. There are three types of administrative methods for collecting the tax withholding due: cash/check, withhold shares for taxes due, sell shares for taxes due.
 - b. If an 83(b) election is filed, then taxation is accelerated to the purchase or acquisition date for all shares under the award.
 - c. Employee will assume tax liability if filing an 83(b).
 - d. Company required to collect taxes upon 83(b) election.
 - e. 83(b) election must be made within 30 days from the grant date.
- 2) Income tax reported at vest/release or at grant and reported on Form W-2 for employees/former employees and 1099-MISC for consultants/outside directors.
- 3) Withholding generally includes federal, social security, Medicare and state taxes, as applicable.
- 4) The company may take a deduction for the amount of ordinary income incurred as along as the income is reported appropriately.
- 5) Administratively, collecting check payments for taxes at vest may be problematic. Companies can also consider payroll withholding, share withholding, or sale of shares to cover taxes.
- 6) Dividends earned on unvested restricted shares are considered compensation income, not dividend income.

Accounting Considerations

- 1) Fair value is equal to value of underlying stock (i.e., intrinsic value) at grant date.
- 2) Measurement date is grant date.
- 3) Under FAS123R-2, grant date is determined as the date where the company has communicated key terms and conditions (grant date, price, # shares, expiration date, etc.) within a "reasonable" timeframe.
- 4) Expense is recorded over the service period, requiring a forfeiture rate estimate to be applied.

³ Applies to US tax consequences only – please consult your global tax compliance expert for specifics on a country-by-country basis.

Benefits Guidance Report

IV. Restricted Stock Unit (RSU)

Taxation Considerations⁴

- 1) Unlike Restricted Stock (which is governed by IRC §83), RSUs governed by IRC §451 and 409A.
- 2) FICA taxation due on current valuation at vest date; income taxation applicable at release of shares (based on current value at release date). Deferrals possible if written into grant agreements.
- 3) Income tax reporting at vest/release reported on Form W-2 for employees/former employees and 1099-MISC for consultants/outside directors; withholding generally includes federal, social security, Medicare and state taxes, as applicable; company may take a deduction for the amount withheld and paid to the IRS on behalf of the employee.
- 4) Administratively, collecting check payments for taxes at vest may be problematic. Companies can also consider payroll withholding, share withholding, or sale of shares to cover taxes.
- 5) Deferrals (i.e., deferring income taxation until release date) can be elective or mandatory.
 - a. Does not defer FICA taxation at vest, only income taxation at release.
 - b. If shares used to cover FICA taxation at vest, income taxation will apply on the shares sold/withheld.
 - c. ERISA considerations
 - d. Deferral can be until a specified date or event.
- 6) The company may take a deduction for the amount of ordinary income incurred as long as the income is reported appropriately.

Accounting Considerations

- 1) Fair value is equal to value of underlying stock (i.e., intrinsic value).
- 2) Measurement date is grant date.
- 3) Under FAS123R, grant date is determined as the date where the company has communicated key terms and conditions (grant date, price, # shares, expiration date, etc.) within a "reasonable" timeframe.
- 4) If RSU paid in stock only, accounting treatment the same as restricted stock. If will be paid in cash or election of cash or stock, FAS123R requires companies to account for RSUs as liabilities (i.e., marked to fair value as of each interim accounting date until award settled).
- 5) Expense is recorded over the service period, requiring a forfeiture rate estimate to be applied.

⁴ Applies to US tax consequences only – please consult your global tax compliance expert for specifics on a country-by-country basis.

Benefits Guidance Report

V. Stock Appreciation Right (SAR)

Taxation Considerations⁵

- 1) Tax treatment of a stock settled SAR is similar to a Non-Qualified stock option, governed by IRC §83. Stock settled SARs also regulated by IRC §451.
- 2) Less dilutive than stock options – holders are not required to sell shares to pay an exercise price.
- 3) Potential solution to residual loan issue by cashless exercises of stock options (does not involve any extension of credit and therefore does not violate SOX §402 prohibition of extending credit to an executive director or officer).
 - a. May trigger deferred compensation issues under IRC §409A.
- 4) No taxation at grant (grant does not constitute the receipt of “property” within the meaning of IRC §83).
- 5) SARs granted at Fair Market Value are taxed at exercise.
 - a. Other circumstances may arise under deferred compensation features.
- 6) As with stock options, company may take a deduction for the amount of ordinary income incurred as long as the income is reported appropriately.

Accounting Considerations

- 1) Accounting treatment under FAS123R is on par with stock options – fair value measured at grant and recognized over the service period.
- 2) To minimize accounting expense, companies may decide to limit or “cap” the maximum appreciation realizable by the holder (example: a multiplier of 2 or 3 times the value of the underlying shares at the date of grant). However, this will potentially trigger income to the employee at the earlier of:
 - a. Date the cash is paid or shares transferred.
 - b. Date the SAR is exercisable and appreciation ceiling is reached.
- 3) 162(m) considerations
 - a. Treatment would generally follow the same as non-qualified stock options.
 - b. Annual per person share limit should be broadly written in the plan document to exempt stock-settled SARs for 162(m) purposes.
- 4) 280G (golden parachute) considerations apply to SARs – same as the rules applicable to stock options.

⁵ Applies to US tax consequences only – please consult your global tax compliance expert for specifics on a country-by-country basis.

VI. Performance Options and Awards

Service Conditions are the most frequent type of condition for an option or award to be earned. If an employee works for the company and is “in service” to the company, the equity award will be earned.

Other types of options or awards are granted with certain terms and conditions that allow the recipient to “earn” the shares only after some type of performance is met. These may be revenue goals, profits, EPS, ROI, sales goals, etc. Market goals are also a performance condition.

Performance awards may also carry both a performance goal and a service condition whereby if the first is not met then the service condition may be met and therefore allows the recipient to earn the shares.

Taxation Considerations⁶

- 1) Tax treatment of Performance Options and Awards will follow the same taxation regulations for a Non-qualified or Incentive Stock Option, whichever is granted. As long as the incentive option follows the regulations under IRC Sec 422, then all such taxation rules apply.
- 2) May trigger deferred compensation issues under IRC §409A if a deferral feature is part of the options terms.
- 3) The company may take a deduction for the amount withheld and paid to the IRS on behalf of the employee.

Accounting Considerations

- 1) Accounting treatment under FAS123R states that performance options and awards must be fair-valued using a fair valuation model.
 - a. Awards that have performance conditions that are NOT market-based may be fair valued using the Black-Scholes model.
 - b. Awards that have market-based goals typically MUST use the Monte Carlo method as this model ties the expectations of the company’s market price to the model.
 - c. Complexities arise for the expense allocation treatment when both a performance and service condition are combined in the terms of the grant.
- 2) Fixed-plan accounting treatment that allows grant-date fair value.
 - a. Performance-accelerated vesting may be valued under fixed-plan accounting treatment.
 - b. Premium-priced options may be fair valued on grant date.
- 3) Variable-plan accounting or liability accounting
 - a. Certain features of a performance award may require mark-to-market valuation each reporting period until the award is settled or vested.

⁶ Applies to US tax consequences only – please consult your global tax compliance expert for specifics on a country-by-country basis.

FRS History and Services

Founded in 2000 by Marianne Brannock-Hill, CEP, CTP, FRS Equity Strategies is the full-service provider of choice for the full array of equity compensation services, from consulting and outsourcing to training. We take a team approach, applying just the right skills and expertise to deliver a solution tailored to meet your needs. This approach also adds an important level of internal accountability and auditing. Our goal is to provide services as seamlessly as though we were members of your internally staffed equity compensation team.

We provide the following services to both private and publicly-owned companies. We work with a wide range of organizations from start-up to Fortune 1000 companies. Our professional staff is comprised of individuals with advanced degrees and certifications in accounting, tax, law and business. We are SAS70 certified, ensuring that our processes meet the highest standards of security and confidentiality. For further details on all our services, please visit our website: www.frsequitystrategies.com, email us: clientservices@equity-strategies.com, or call (408) 727-0227.

Out-Sourcing

- We provide a full-service management and administration service customized to the needs of your organization and your current processes.
- Our services cover all aspects of employee equity plan management, addressing up to 50% more corporate responsibilities than those handled by brokers, law firms, or other third-party vendors.
- Our team is highly experienced with a variety of equity plan management software suites including those from EASi, EMS, eProsper, E*Trade, Equity Edge, Transcentive and more.

Consulting

- We offer services on a project-basis to provide you with a variety of assistance with the management of your employee equity plans.
- FAS 123(R) valuation and expense allocation reporting.
- Database integration related to mergers and acquisitions.
- Software implementation for new applications and transitions between applications.
- Audits of historical data and ongoing processes for compliance.
- Other special projects as needed.

Training

- Remote or onsite training services to maintain the technical expertise of your staff.
- Seminars and “boot-camps” on regulations, accounting, tax and compliance issues.
- Courses in the use of equity plan management software applications.
- CEP exam preparation sessions for levels 1, 2 & 3 of certification.