STOCK-BASED COMPENSATION CAN HELP TIP THE HIRING SCALE YOUR WAY

THE BOTTOM LINE

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What happens when your small or medium-sized private company finds itself in head-to-head competition with a larger public company for key talent? Or when your growing private company in a geographically remote location needs to fill a management position for which the prime candidates are in companies in major metropolitan areas? Too often, the answer is that the talent that could help your company make the leap to the next level ends up somewhere else. The resources of the public company, the differences in value for the positions from market to market, or the salary and benefit expectations of these prospects can price your small or medium-sized private company right out of the competition.

While you can’t always avoid these issues, there are ways to level the playing field that can help you attract, win and retain those hard-to-find key players. One of these is non-cash compensation, specifically, stock options and restricted stock awards.

THE BENEFITS OF STOCK-BASED COMPENSATION

The most obvious and immediate benefit of stock-based compensation for private companies is that it helps smaller companies and companies in small or remote markets attract and hire highly qualified employees—without requiring massive cash outlays. Typically these employees expect certain levels of benefits and compensation. Options and stock awards, offering the potential to pay handsomely down the road, can tip the hiring scale in your direction.

Once you have found and hired these key employees, stock options and awards can help you retain them. In addition, ownership in the company can lead to greater employee loyalty and stronger commitment to the success of the business.

Stock-based compensation is also a good way to recognize the contributions of current employees, again without cash outlays. Options and stock awards provide incentives for your key employees to remain in the business and focus on company growth that will, in turn, increase the value of their stock.

FINANCIAL IMPLICATIONS OF STOCK-BASED COMPENSATION

The three main types of stock-based compensation and the way each impacts your company from a book and tax perspective are outlined in the chart that follows.

TYPE OF NON-CASH COMPENSATION	NON-QUALIFIED STOCK OPTION (NSO)	INCENTIVE STOCK OPTION (ISO)	RESTRICTED STOCK AWARD (RSA)
To Whom May Options or Awards be Granted?	Can be granted to employees, independent contractors, non-employee directors and others	Can be granted only to employees	Can be granted to employees, independent contractors, non-employee directors and others
Book Treatment Under ASC 718	**On grant date:** measure the option's fair value. **Over the requisite service period:** recognize compensation cost and the deferred tax asset, adjusted for pre-vesting forfeitures. **On settlement date:** Compare the tax deduction with the cumulative book compensation cost. When the tax deduction is greater than the cumulative book compensation cost, the benefit of the excess deduction is a windfall tax benefit. When the deduction is less than the cumulative book compensation cost, a shortfall occurs. A windfall is credited to APIC and a shortfall is debited to APIC and/or tax expense.	Treated the same way as NSOs when recognizing book compensation cost under ASC 718. Treated differently for the related income taxes. Ordinarily ISOs do not result in a tax benefit for the employer. When recognizing compensation cost for book purposes, a deferred tax asset is not recognized. ISOs generally will not result in shortfalls and windfalls can occur only upon a disqualifying disposition such as the recipient disposing of the stock before the end of the statutory holding period.	**On grant date:** measure the award's fair value. **Over the requisite service period:** recognize compensation cost and the deferred tax asset, adjusted for pre-vesting forfeitures. **On settlement date:** Compare the tax deduction with the cumulative book compensation cost. When the tax deduction is greater than the cumulative book compensation cost, the benefit of the excess deduction is a windfall tax benefit. When the deduction is less than the cumulative book compensation cost, a shortfall occurs. A windfall is credited to APIC and a shortfall is debited to APIC and/or tax expense.
Tax Implications for Employer	Employer is entitled to a compensation deduction for its taxable year within which the employee recognized ordinary income upon exercise.	No compensation deduction when employee exercises unless there is a subsequent disqualifying disposition. If employee recognizes ordinary income on the sale of shares acquired upon exercise due to the disqualifying disposition, the employer can take a deduction equal to the amount of ordinary income recognized by the employee.	Employer will be entitled to a compensation deduction for its taxable year within which the employee recognized ordinary income upon vesting.
Tax Implications for Employee/Recipient	NSOs are not taxable to the recipient at the grant date unless they have a "readily ascertainable fair market value" at the time they are granted—which is not typically the case—and are not taxable at vesting. The difference between the grant price and the stock price at exercise is taxable income at the time the option is exercised. At disposition of the stock, the recipient will have a capital gain equal to the difference between the stock price and the basis (the sum of the exercise price and income recognized when the option is exercised).	ISOs are not taxable to the recipient at the grant date or at vesting. There are also no regular income tax implications at exercise unless the stock is not sold in the calendar year in which the option is exercised. In that case, the exclusion from income is ignored in computing alternate minimum taxable income. Tax consequences at disposition of the options differ depending on whether or not the options were held for the statutory holding period. Income from options held for at least the statutory holding period is taxed as a long term capital gain. Disposing of ISO granted stock prior to the end of the statutory holding period is a "disqualifying disposition" and is treated as ordinary income that is added to the stock's basis to determine the capital gain. The capital gain may be either long term or short term depending on how long the stock is held.	RSAs are not taxable to the recipient at the grant date. At vesting, the fair market value at the time of vesting will be recognized as ordinary income. When a recipient disposes of RSAs, all gain on the sale is subject to capital gain treatment, which is calculated as the difference between the sale price and the basis (the income recognized upon vesting).

To illustrate the differences in how the three types of non-stock compensation affect taxes as the grantor and recipient of the option or award, assume an award with a fair market value of $100 at grant date. Your stock does well, and at vesting the fair value is $200; at exercise, $300 and when the recipient disposes of the stock, $400. In all cases, the exercise price is the price at which the stock award was granted—$100.

The tax implications for this example would be:

	NONQUALIFIED STOCK OPTIONS	INCENTIVE STOCK OPTIONS	RESTRICTED STOCK AWARDS
At Grant Date	Grantor: No deduction Recipient: No income	Grantor: No deduction Recipient: No income	Grantor: No deduction Recipient: No income
At Vesting Date	Grantor: No deduction Recipient: No income	Grantor: No deduction Recipient: No income	Grantor: $200 deduction Recipient: $200 income
At Exercise Date	Grantor: $200 deduction Recipient: $200 income	Grantor: No deduction Recipient: $200 AMT income	Grantor: Not applicable Recipient: Not applicable
At Disposition	Grantor: No deduction Recipient: $100 capital gain	Grantor: No deduction Recipient: $300 capital gain	Grantor: No deduction Recipient: $200 capital gain

HOW WILL OFFERING STOCK-BASED COMPENSATION IMPACT CURRENT OWNERS?

While stock-based compensation offers real benefits for both employees and companies, you may have questions about how it would work in your situation. The most common initial concern is how offering stock-based compensation to employees will affect the current owners.

It is true that the only way to offer stock to employees is to divest current owners of some of their equity (stock) in the company. On the other hand, the purpose of doing that is to attract and retain the best people you can. The right people in key positions can help you increase the value of your company, making the percent of the company you own more valuable than if you retain 100% ownership and are not able to hire these key players.

Another concern may be the complexity of implementing a plan: determining which type of option plan or award would be best for your company; understanding the book and tax implications both for the company and recipients; and deciding how to set up, implement and administer the plan.

While developing the plan and ensuring that accounting and tax considerations are handled correctly can be a somewhat daunting undertaking, you don't have to do this on your own. Organizations with expertise in these areas, Horne among them, can assist you with the technical details of setting up your plan and making sure that potential pitfalls are addressed.

A FEW WORDS ABOUT HORNE LLP

HORNE's knowledgeable professionals understand the nuances of ISO, NSO and RSA plans and the different requirements for each. We would welcome the opportunity to help you assess the benefits of stock-based compensation plans for your business, assist you in identifying the best type of plan for your company, and ensure that your plan is set up correctly. Horne offers a full range of accounting services, including audit services, tax planning, SEC financial reporting assistance, acquisition due diligence, Sarbanes Oxley compliance, enterprise risk management, internal audit, IT consulting, and forensic accounting.

ABOUT THE AUTHORS.

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