

SAN JOSE STATE UNIVERSITY HIGH TECHNOLOGY TAX INSTITUTE

WHAT'S NEW IN COMPENSATION ISSUES AND PLANNING

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AGENDA

- I. Federal Tax Update
- II. Underwater Option Exchange Tax Issues
- III. SFAS 141R (ASC 805) and Equity Comp
- IV. Tax Treatment of ISO Shares Being Sold for Deferred Consideration – A Case Study

I. FEDERAL TAX UPDATE

Final Regs Due under Sections 6039 and 423

- §6039 will require reporting to the IRS for ISO exercises and ESPP "transfers"
 - New forms 3921 (ISOs) and 3922 (ESPPs)
 - In addition to W-2 reporting and reporting to employees already required
 - Probably delayed until 2010
- Final §423 regs for ESPPs expected soon – "hot" topics
 - "Liberal" versus "conservative" method of computing carryover of \$25K annual limit
 - Proposed regs clarify that conservative method applies – option has to be exercisable for \$25K to accrue
 - Potential new restrictions regarding equal rights clauses, excludable employees, determination of grant date, etc.
 - Failure to meet some tests can disqualify entire grant

IRS (& FTB) §409A COMPLIANCE ACTIVITY

Off-record IRS comments and blog-chatter suggests the IRS is planning on increasing its scrutiny of deferred compensation plans and agreements for compliance with Section 409A

The FTB is “mining” SEC filings for California based executives having exercised uncured discounted stock options and is sending out proposed adjustments for Section 409A taxes. The FTB is assuming that an option that is discounted for GAAP purposes is also discounted for Section 409A purposes. The FTB’s position fails to take into account the application of Section 422(c)(1) to options granted prior to January 1, 2005 whether or not such options were ISOs

Notice 2008-113 – 409A correction program for operational failures

Prop. Treas. Reg. §1.409A-4 provides a very limited 409A correction program for certain documentation failures

A more complete 409A correction program for documentation failures is expected soon

RSU WITHHOLDING ISSUES

RSU typically taxable upon delivery (not vesting)

The most common methods of providing for withholding are:

- Withhold in shares
- Same-day sales
- Withholding in shares
 - What is the correct value to use if delivery is to occur on a non-trading day?
 - Cash cost to the company
- Same-day sales
 - What if the sale would occur in a black-out period?
 - What are the deposit due dates?
- Special problems for non-US employees

II. UNDERWATER OPTION EXCHANGE TAX ISSUES

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Option Exchange Tax Issues: 409A & 162(m)

409A

- **409A**: Final regulations generally permit the use of replacement awards that will vest after original term of canceled underwater option
- **NSOs generally exempt if**
 - The exercise price is not less than FMV
 - No other deferral features

162(m)

- **162(m)**: Both underwater options and replacement awards will count against per-employee limit on shares granted under the plan

Option Exchange Tax Issues - ISOs



ISOs

- **ISO for ISO exchange:** Exchange results in double-counting some ISOs for the \$100,000 limit
- **Non-tendered ISOs and 30 day rule:** If the offer to exchange remains open for 30 days or more (including weekend days), eligible ISOs will be considered regranted on the offer date
 - Even for employees who don't tender their ISOs
 - Must meet ISO tests on “new” grant date
 - Restarts the holding periods to achieve qualifying dispositions
 - Watch out for interplay with SEC's 20 day tender offer rule – only counts business days

Option Exchange Tax Accounting

DTA Tracking: Do not reverse deferred tax asset (DTA) for exchanged options when they are cancelled, unless settled for immediate cash payment

- Exchanged option DTA treated as part of DTA for new options or stock awards, which does not reverse until tax event for new award occurs
- Record additional DTA for unamortized cost of original awards over post-exchange vesting period and any incremental cost of new awards
- If ISOs are exchanged for NSOs or RSUs, consider recording DTA and deferred tax benefit in P&L for cumulative book expense previously recorded for any exchanged ISOs

Option Exchange Tax Accounting - continued

Expect deficiencies for new awards

- For example, in a value for value exchange, the DTA associated with expense for the original awards will likely dwarf the ultimate tax benefit received on new awards
- Company might want to forecast APIC Pool availability to absorb shortfalls

New processes will be needed to track DTA associated with cancelled options and reverse it upon later tax event -- few, if any, option accounting systems can do this now

- Additional complications for awards granted prior to ASC 718 (FAS 123R), previously assumed in an acquisition, or where company has cost-sharing agreements
- Watch out for forfeitures that occur after the vest date of original awards
- Don't try this at home!

III. SFAS 141R (now ASC 805) AND EQUITY COMPENSATION

ASC 805 (SFAS 141R) and Equity Compensation

- SFAS 141R changes tax accounting for options, other share-based awards exchanged as part of an acquisition
- Effective for acquisitions in first annual reporting period beginning after 12/15/08
- Companies will have to continue to apply old 141 rules for acquisitions prior to 141R effective date
- Under 141R, companies will:
 - Record less goodwill, more DTA on acquisition date
 - Have bigger shortfalls (aka deficiencies) post-acquisition
 - Record greater tax benefit in the P&L for assumed ISOs

Tax Accounting under 141 and 141R – What Stays the Same?

- Fair value of replacement awards, to the extent attributable to past service ("precombination service"), is included in the purchase price
- Fair value of the unearned portion ("postcombination service") is expensed post acquisition, under normal 123R rules
 - Calculation of DTA, shortfalls, windfalls, APIC: all the same concepts as under 123R
- No carryforward of target's APIC Pool under normal "fresh start" accounting

Tax Accounting under 141 & 141R: What Changes?

DTA recorded on acquisition date under 141R

- DTA is recorded on the acquisition date for the fair value included in the purchase price, for non-statutory awards
 - Reduces the amount of goodwill recorded
 - **Downside:** Future shortfalls written off to APIC Pool, or income tax expense
 - **Upside:** No special tracking for assumed options after acquisition
- Under old 141, no DTA recorded on acquisition
 - Instead, goodwill was reduced upon exercise (or upon vesting for RS/RSUs) up to fair value included in purchase price times tax rate
 - No impact on APIC Pool or tax expense for future “shortfalls”

141 versus 141R: Example

- Assume Buyer substitutes NSOs with Fair Value of \$10M
 - **\$7.5 attributable to past service** ("precombination service" or earned portion)
 - **\$2.5M attributable to future service** ("postcombination service" or unearned portion) *accounted for under normal rules of 123R*
- Under 141R, Buyer will record at purchase:
 - **Goodwill : \$4.5M**
 - **DTA: \$3M** (40% of \$7.5M)
- Under 141, Buyer would have recorded:
 - **Goodwill: \$7.5M**
 - **DTA: Nada** (per EITF 00-23, issue 29(a))

141 versus 141R: Example, continued

- Assume deduction post-acquisition on exercise of NSOs = \$4M
 - 75% or \$3M (\$1.2 tax effected) allocated to the precombination service
- Under 141R, Buyer will record on exercise (*just for the pre-combination part*):
 - Dr. Taxes Payable \$1.2M
 - Cr. DTA 3.0M
 - **Dr. APIC or Tax Expense** 1.8M
- If under 141, Buyer would record:
 - Dr. Taxes Payable \$1.2M
 - Cr. Goodwill 1.2M
- *Note: for the postcombination service portion, entries will be the same under both old and new guidance (normal accounting under 123R)*

Tax Accounting for ISOs under 141 versus 141R: What Changes?

If Buyer had issued ISOs in exchange for target options, no DTA under either 141R (ASC 805-740) or 141

Treatment of post-acquisition ISO disqualifying dispositions?

- Check with auditors - two acceptable methods?
 1. P&L benefit up to fair value of award on purchase date (including both pre and postcombination service) times tax rate, on award by award basis.
Excess benefit to APIC
 - Note that this gives company a P&L benefit for amounts not included in expense (the precombination service portion included in purchase price)
 2. Entire tax benefit of disqualifying disposition goes to APIC
- *Under 141, company could only record P&L benefit for expense recognized post acquisition*

IV. TAX TREATMENT OF ISO SHARES BEING SOLD FOR DEFERRED CONSIDERATION – A CASE STUDY

SALE OF ABC INC. – ASSUMED FACTS

ABC Inc. is being sold for cash. There will be a maximum of \$5.75 per share in 2 payments:

An upfront payment of \$4.17 per share will be paid in 2009

If the milestone described in the Merger Agreement is achieved, \$1.58 per share will be paid in 2011 (the “earnout payment”)

For simplicity, we will assume that \$0.02 of any earnout payment will be imputed interest

ABC, Inc. is privately held and, with the possible exception of §421(b), the installment method is available to the selling stockholders

THE SELLING STOCKHOLDERS

There are 3 selling stockholders: Mary, Sally and Fred. Each of the stockholders exercised an ISO for 1,000 shares. The exercise price was \$0.50 per share. The ISO had been granted more than 2 years prior to the closing.

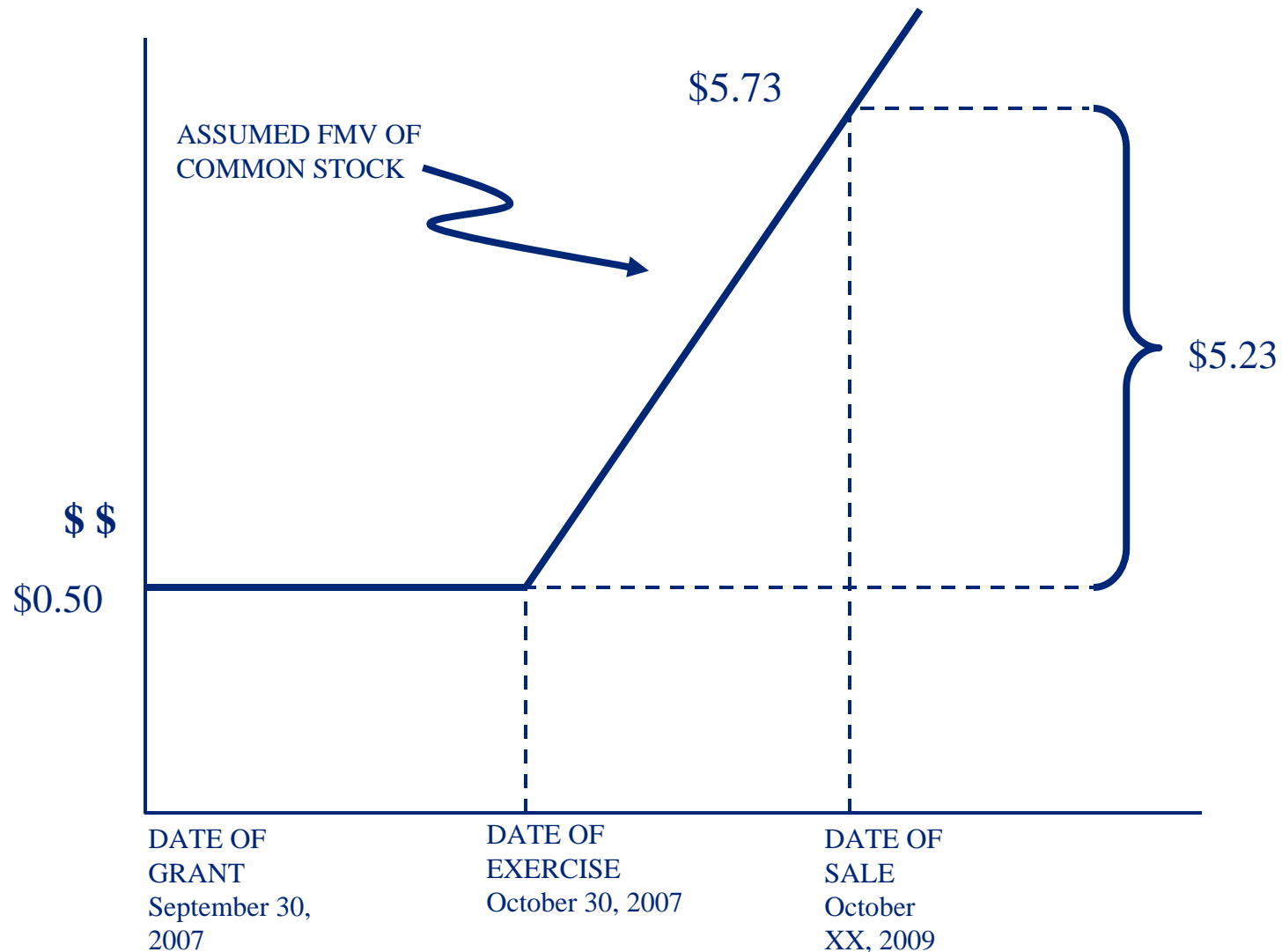
Mary's exercise occurred more than 1 year prior to the closing so her sale will be a qualifying disposition

Sally and Fred each exercised their ISOs less than 1 year prior to the closing so each of their sales will be a disqualifying disposition

WE WILL NOT BE COVERING

- State tax consequences
- Alternative minimum tax (AMT) consequences
- Estimated tax payment requirements
- Tax consequences of electing out of installment sale reporting or the mechanics of electing out of installment sale reporting
- Tax consequences of amending tax returns
- Tax rate issues (e.g., ordinary income, long-term and short-term capital gains, AMT tax rates) as to differentials or changes
- Golden parachute excise taxes (IRC Section 4999)
- Qualified small business stock (QSBS) rules (IRC Section 1202) or QSBS rollover rules (IRC Section 1045)

Example 1 – Mary: Qualifying Disposition and No Spread on Exercise – Full Payment Received



Example 1A – Results If No Spread on Exercise (Sale > 2 years from grant & > 1 year from exercise)

Tax consequences of sale assuming full payment received (per share)

- Long-term capital gain = \$5.23
- Short-term capital gain = 0
- Ordinary income (sales proceeds) = 0
- Ordinary income (imputed interest) = \$0.02

Application of the Installment Method to Calculate Gain

Basic rule – multiply sales proceeds received by gain inclusion ratio (GIR)

- Gain inclusion ratio (“GIR”) is
 - Maximum potential gain (maximum payments (\$5.75) minus imputed interest minus exercise price); divided by
 - Maximum potential sales proceeds (maximum payments (\$5.75) minus imputed interest (\$0.02))
 - In our example: $GIR = (5.75 - 0.02 - 0.50) / (5.75 - 0.02) = 0.9127$

Upfront payment (2009)

- In our example: $4.17 \times GIR = \$3.81$

Full earnout payment (2011)

- (Cash received minus imputed interest) times GIR
- In our example: $(1.58 - \$0.02) \times GIR = \1.42

Example 1A: Mary Holds ISO Shares at Closing – Qualifying Disposition – Full Payment Received

Assumptions: More than one year ago, Mary exercised 1,000 shares subject to an ISO granted more than 2 years ago

- Exercise price \$0.50
- Assume FMV at time of exercise was \$0.50 (i.e., the spread was zero)

Upfront payment (2009)

- Cash consequences: Mary receives \$4,170 (\$4.17 per share)
- Tax consequences
 - \$3,810 long-term capital gain (\$3.81 per share)
 - None of the gain is subject to withholding or FICA

Earnout distribution (2011)

- Cash consequences: \$1,580 (\$1.58 per share)
- Tax consequences: \$1,420 long-term capital gain (\$1.42 per share)
- Tax consequences: \$20 ordinary (interest) income (\$0.02 per share)

Example 1B: Mary Holds ISO Shares at Closing – Qualifying Disposition – No Earnout Received

Assumptions: Same as 1A except no earnout received

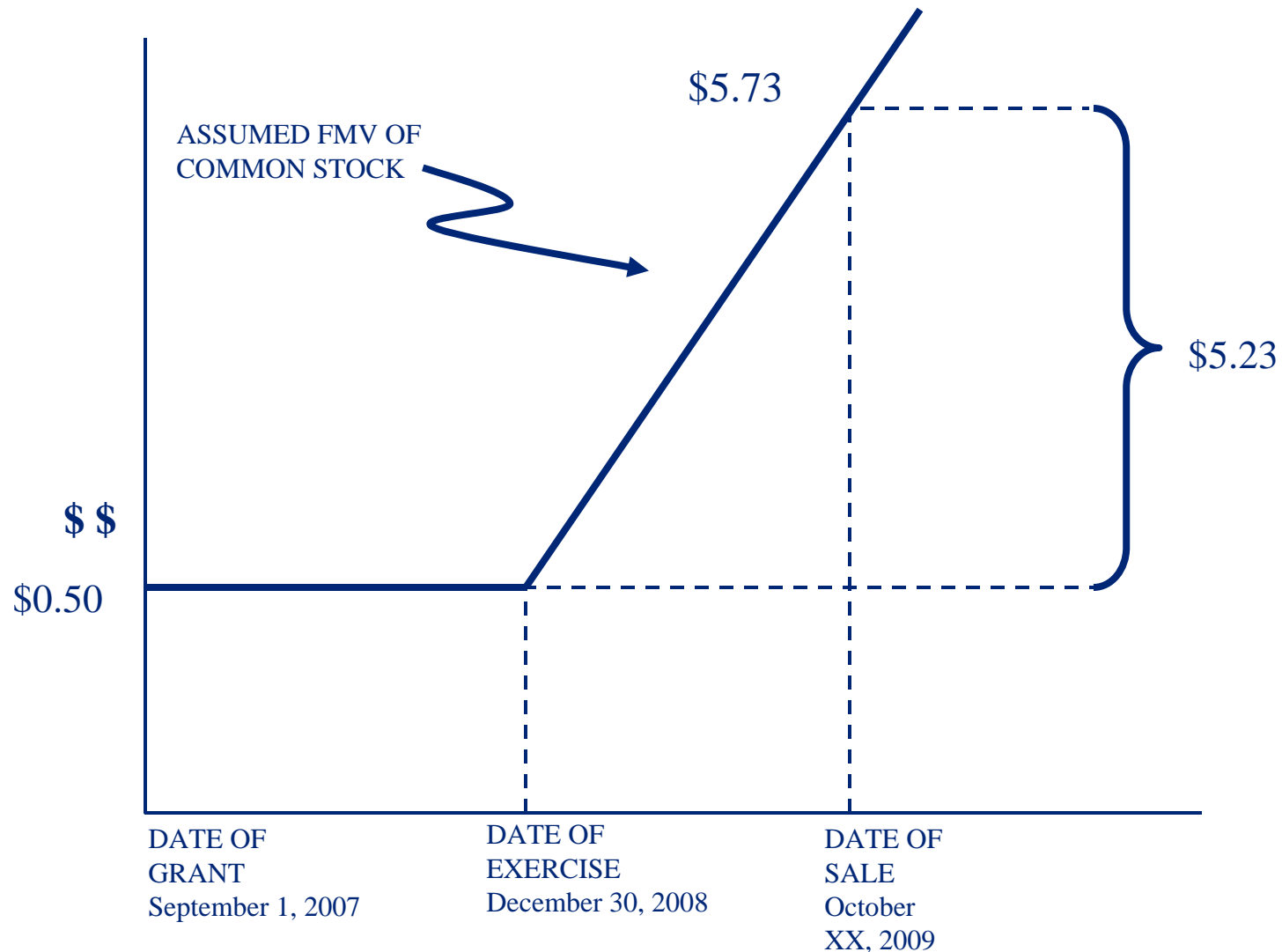
Upfront payment (2009)

- Cash consequences: Mary receives \$4,170 (\$4.17 per share)
- Tax consequences
 - \$3,810 long-term capital gain (\$3.81 per share)
 - None of the gain is subject to withholding or FICA

Earnout distribution (2011)

- Cash consequences: \$0
- Tax consequences: \$140 long-term capital loss (\$0.14 per share)
 - Capital loss trues up recognized gain to total gain
 - Sales proceeds of \$4.17 less basis of \$4.31 (\$0.50 exercise price + \$3.81 gain recognized in 2009)

Example 2 – Disqualifying Disposition and No Spread on Exercise – Full Payment Received – Shares Vested on Exercise



Example 2A – Results If No Spread on Exercise (Sale =< 2 yrs from grant OR =< 1 yr from exercise)

Tax consequences of sale assuming full payment received (per share)

- Ordinary income (sales proceeds) = 0
- Short-term capital gain = \$5.23
- Long-term capital gain = 0
- Ordinary income (imputed interest) = \$0.02
- Note: the gain is short-term capital gain because the period from the exercise date to the sale date was 1 year or less

Application of the Installment Method to Report Gain

Basic rule – multiply sales proceeds received by gain inclusion ratio

- Gain inclusion ratio (“GIR”) is
 - Maximum potential gain (maximum payments (\$5.75) minus imputed interest minus exercise price); divided by
 - Maximum potential sales proceeds (maximum payments (\$5.75) minus imputed interest (\$0.02))
 - In our example: $GIR = (5.75 - 0.02 - 0.50) / (5.75 - 0.02) = 0.9127$

Upfront payment (2009)

- In our example: $4.17 \times GIR = \$3.81$

Full earnout payment (2011)

- (Cash received minus imputed interest) times GIR
- In our example: $(1.58 - \$0.02) \times GIR = \1.42

Example 2A: Sally Holds ISO Shares at Closing – Disqualifying Disposition – Full Payment Received – Shares Vested on Exercise

Assumptions: Less than one year ago, Sally exercised 1,000 shares subject to an ISO granted more than 2 years ago. The shares were vested on her exercise (i.e., the exercise date is the determination date)

- Exercise price \$0.50
- Assume FMV at time of exercise was \$0.50 (i.e., the spread was zero)

Upfront (2009)

- Cash consequences – Sally receives \$4,170 (\$4.17 per share)
- Tax consequences
 - \$3,810 short-term capital gain (\$3.81 per share)
 - None of the gain is subject to withholding or FICA

Earnout distribution (2011)

- Cash consequences: \$1,580 (\$1.58 per share)
- Tax consequences: \$1,420 short-term capital gain (\$1.42 per share)
- Tax consequences: \$20 ordinary (interest) income (\$0.02 per share)

Example 2B: Sally Holds ISO Shares at Closing – Disqualifying Disposition – No Earnout Payment Received – Vested on Exercise

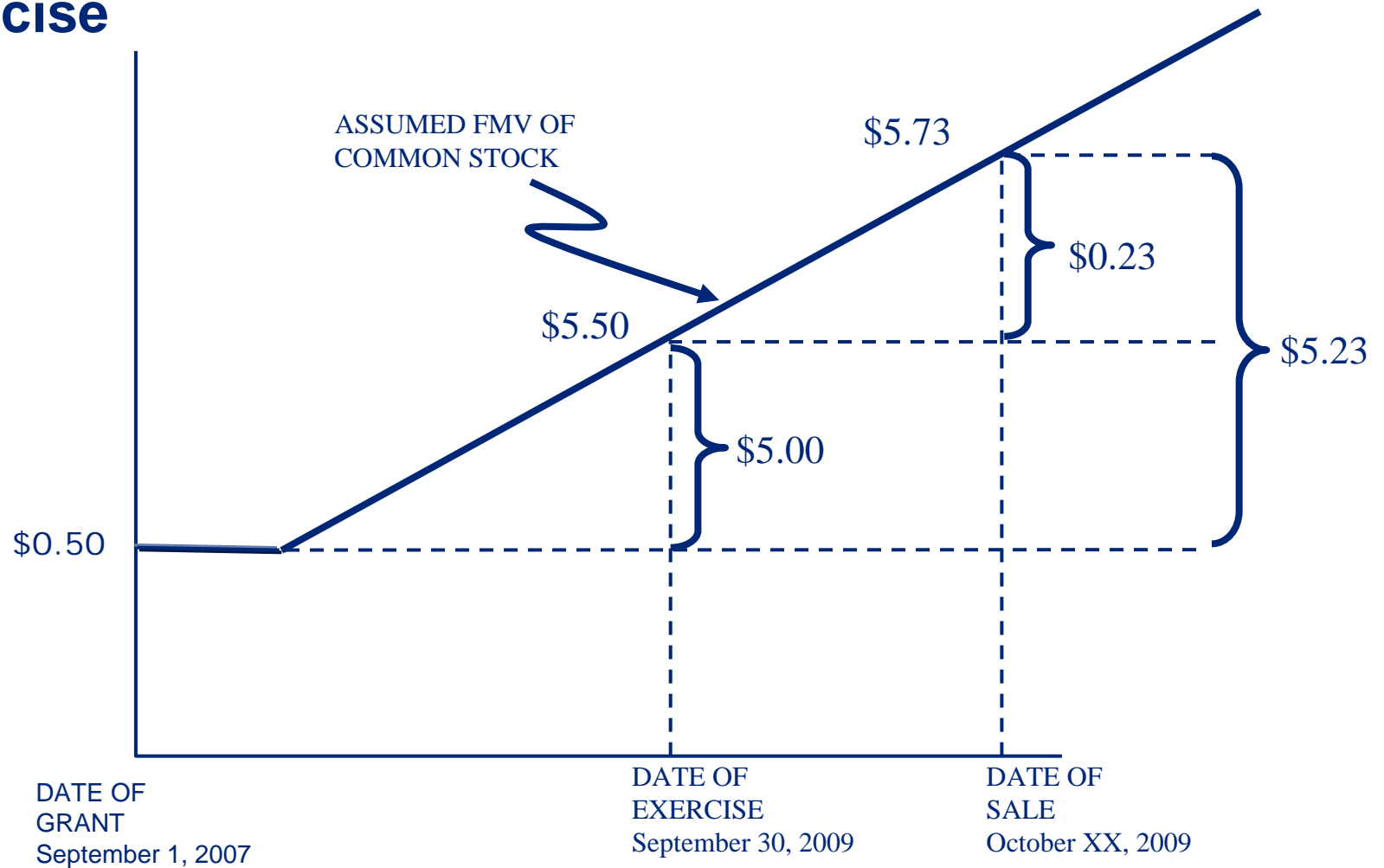
Assumptions: same as Example 2A except no earnout payments are received

Upfront: same as Example 2A

No earnout payment

- Cash consequences: none
- Tax consequences: \$140 short-term capital loss (\$0.14 per share)

Example 3 – Disqualifying Disposition with Spread on Exercise – Full Payment Received – Shares Vested on Exercise



Example 3A – Spread on Exercise

(Sale =< 2 yrs from grant OR =< 1 yr from exercise)

Tax consequences of sale assuming full payment received (per share)

- Ordinary Income (sales proceeds) = \$5.00
- Short-term capital gain = \$0.23
- Long term capital gain = 0
- Ordinary income (imputed interest) = \$0.02
- Note: the capital gain is short term capital gain because the period from the vesting date to the sale date was 1 year or less

Does the Installment Method Apply to the Ordinary Income Component in a Disqualifying Disposition?

I. YES: §453 trumps §421(b):

- Exclude ordinary income when computing GIR
- Gain recognized is characterized as ordinary income first until all ordinary income is recognized and then capital gain is recognized

II. NO: §421(b) trumps §453:

- All ordinary income is recognized in the year of sale
- §453 applies only to any capital gain portion of the gain

§421(b): If the transfer of a share of stock to an individual pursuant to his exercise of an [incentive stock] option would otherwise meet the requirements of section 422(a) ... except that there is a failure to meet any of the holding period requirements of section 422(a)(1) ..., then any increase in the income of such individual ... for the taxable year in which such exercise occurred attributable to such disposition, shall be treated as an increase in income ... in the taxable year of such individual ... in which such disposition occurred.

I. Application of the Installment Method to Report Gain – Ordinary Income and Capital Gains

Basic rule – multiply sales proceeds received by gain inclusion ratio

- Gain inclusion ratio (“GIR”) is
 - Maximum potential gain (maximum payments (\$5.75) minus imputed interest minus exercise price); divided by
 - Maximum potential sales proceeds (maximum payments (\$5.75) minus imputed interest (\$0.02))
 - In our example: $GIR = (5.75 - 0.02 - 0.50) / (5.75 - 0.02) = 0.9127$

Upfront payment (2009)

- In our example: $4.17 \times GIR = \$3.81$ (all ordinary)

Full earnout payment (2011)

- (Cash received minus imputed interest) times GIR
- In our example: $(1.58 - \$0.02) \times GIR = \1.42 of which \$1.19 is ordinary income and \$0.23 is short-term capital gains

II. Application of the Installment Method to Report Gain – Capital Gains Only

Basic rule – multiply sales proceeds received by gain inclusion ratio

- Gain inclusion ratio (“GIR”) is
 - Maximum potential gain (maximum payments (\$5.75) minus imputed interest minus exercise price minus ordinary income); divided by
 - Maximum potential sales proceeds (maximum payments (\$5.75) minus imputed interest (\$0.02))
 - In our example: $GIR = (5.75 - 0.02 - 0.50 - 5.00) / (5.75 - 0.02) = 0.0401$

Upfront payment (2009)

- In our example: $4.17 \times GIR = \$0.17$ short-term capital gain

Full earnout payment (2011)

- (Cash received minus imputed interest) times GIR
- In our example: $(1.58 - \$0.02) \times GIR = \0.06 short-term capital gain

Example 3A: Fred Holds ISO Shares at Closing – Disqualifying Disposition – Full Payment Received

Assumptions: Shortly before the closing, Fred exercised his ISO for 1,000 shares. The shares were vested on his exercise

- Exercise price \$0.50
- Assumed FMV at time of exercise was \$5.50 (i.e., the spread was \$5.00 per share)

Upfront

- Cash consequences: Fred receives \$4,170 (\$4.17 per share) (but note that he had to pay \$0.50 per share to exercise his ISO)
- Tax consequences: (2009)
 - None of the gain is subject to withholding or FICA
 - See chart on next slide

Earnout payment (2011)

- Cash consequences: \$1,580 (\$1.58 per share)
- Tax consequences: See chart on next slide

Example 3A: Fred Holds ISO Shares at Closing – Disqualifying Disposition – Full Payment Received

2009	I. §453 trumps §421(b)	II. § 421(b) trumps §453
Ordinary income	\$3,810 (\$3.81 per share)	\$5,000 (\$5.00 per share)
Short-term cap gain	0	\$170 (\$0.17 per share)

2011	I. §453 trumps §421(b)	II. § 421(b) trumps §453
Ordinary income	\$1,190 (\$1.19 per share)	0
Short-term cap gain	\$230 (\$0.23 per share)	\$60 (\$0.06 per share)
Ordinary income (imputed interest)	\$20 (\$0.02 per share)	\$20 (0.02 per share)

Example 3B: Fred Holds ISO Shares at Closing – Disqualifying Disposition – No Earnout Payment Received

Assumptions: same as Example 3A

Upfront: same as Example 3A (2009)

No earnout payment (2011)

- Cash consequences: none
- Tax consequences: See next slide

Note: As Fred will only have received \$4.17 per share and his exercise price was \$0.50 per share, his overall gain for 2009 and 2011 should be \$3.67 per share

Example 3B: Fred Holds ISO Shares at Closing – Disqualifying Disposition – No Earnout Received

2009	I. §453 trumps §421(b)	II. § 421(b) trumps §453
Ordinary income	\$3,810 (\$3.81 per share)	\$5,000 (\$5.00 per share)
Short-term cap gain	0	\$170 (\$0.17 per share)

2011	I. §453 trumps §421(b)	II. § 421(b) trumps §453
Ordinary income	0	0
Short-term cap loss	<\$140> (\$0.14 per share)	<\$1,400> (\$1.40 per share)
Ordinary income (imputed interest)	0	0

Closing Observations

If Fred had had his ISO cashed out by a payment in 2009 of \$4.17 per share minus his exercise price of \$0.50 per share and a payment in 2011 of any per share earnout payment:

- He would have avoided the installment method question
- His ordinary income in 2009 would have been less than even Alternative I (because his full exercise price is an offset)
- He would have no concerns regarding possible capital losses

BUT

- He would have been subject to income tax withholding and FICA
- Alternative II might have been more attractive if the full earnout is received and tax rates in 2011 are higher than 2009