GRANTS OR AWARDS OF STOCK (OR OWNERSHIP INTERESTS) TO KEY EMPLOYEES

It is not unusual for owners of an independent financial services business to seek to reward key staff members with a grant of stock or ownership interests, but the strategic planning and tax consequences must be carefully considered and thoroughly explored beforehand.

KEY POINTS

1. In almost every case, the grant of stock to a key employee (also called "equity compensation") is taxed at ordinary income tax rates.

2. Stock grants or awards can be an excellent strategy, but generally work best as part of a broader, long range plan that is designed to help key employees buy into ownership over time.

3. Stock grants should be issued from the Company, not the founding or majority owner.

There are a number of reasons why a gift of an ownership interest in a financial services or advisory practice might seem to make sense. In the case of a transfer between family members, a gift may be the true intent of a parent who wishes to reward a son or daughter for reaching the maturity level necessary to successfully handle the benefits and responsibilities of business ownership. The parent may also consider the gift to be an advance on the son or daughter's inheritance.

In transfers between family members and transfers between non-family members, another perceived advantage of a gift or grant is that it does not require the paperwork and administration that come with a formal sale. When one considers the common situation of a young buyer who must finance his or her purchase of an ownership interest, the temptation becomes even stronger to remove what appears to be the needless complexity of a sale and payment terms over time.

Sellers swayed by those reasons might overlook—or misunderstand—a more important consideration, which is taxes. The potential for misunderstanding stems from Section 102 of the Internal Revenue Code. Section 102(a), on its face, provides the rule that gifts are not subject to federal income tax. However, Section 102(c) provides that gifts from an employer to an employee are fully taxable to the employee as ordinary income.

Not only are such gifts subject to state and federal income tax, but they are treated as employee compensation to be reported on Form W-2—meaning that the employer must pay and withhold employment taxes on the value of the ownership interest gifted to the employee. For this reason, stock or ownership grants are often referred to as "equity compensation."

At this point, business owners may believe that adverse tax results can be avoided by making a gift of an ownership interest to a non-employee, such as an independent contractor. Without considering the legal issues that surround a business's attempt to define or redefine a worker's status, and furthermore assuming the business successfully does that, such a gift will likely fail to provide the optimal tax result.

This is due to a U.S. Supreme Court case, Commissioner v. Duberstein. In that case, the Court defined a "gift," for federal tax purposes, as a transfer of property made out of the donor's "detached and disinterested generosity." In most situations, the IRS finds that a gratuitous transfer of property made in the context of a business relationship is neither "detached" nor "disinterested." On the contrary, a majority owner is often intensely involved and interested in the effect that a new owner has upon the business. Such a "gift" is taxed to the recipient as ordinary income.

Taxation on the transference of shares or an ownership interest can be complicated, and the advice of a CPA or tax attorney should be sought in every instance involving the purchase, sale or granting of stock in a business. However, the following rules can generally be applied:

a) Fair Market Value / Basis: The taxable fair-market value of shares transferred to employees (such as through equity compensation or a stock grant) is the value of the stock, less any amount paid by the employees from their own funds for the shares – and this amount becomes the recipient's basis in the stock.

b) Company Withholding / Deductibility: The Company can deduct the taxable value of the shares given as a benefit of employment in the year that employees claim the value of shares received as part of their income taxes. While this substantially shifts the tax burden to the employee, the employer is still responsible for the payment of payroll taxes on the value transferred.

c) Vesting Issues: If the granted shares are restricted shares and the restrictions create a "significant risk of forfeiture" because the conditions may not be met, then the employee has a choice about taxes: either pay taxes in that year, or wait and pay taxes in the year that the transfer restrictions expire. He or she can file an "83(b) election" (within 30 days of receiving the stock) and choose to pay ordinary income tax on the value of the shares (their fair market value minus any amount paid for them) at the time of the grant. No additional tax is owed until those shares are sold and then the owner of those shares will pay capital gains tax on the difference between the value declared for the 83(b) election and the sale price. If the employee fails to meet the conditions, however, and receives no shares (i.e., the shares are eventually forfeited), the tax paid cannot be recaptured. If the employee does not file this election, then when the shares are received (not sold), the employee pays ordinary income tax on their current fair market value minus any consideration paid for them.

Succession-Based Granting Strategies: Because a vesting schedule can interfere with the shareholder's ability to receive profit distributions, most succession planning strategies utilized by independent financial service owners do not rely on this strategy for tax mitigation. Instead, stock grants are more commonly used to augment a key employee's purchase of stock, serving as reward and motivation for the extended tenure required to pay for ownership out of profit distributions and future growth on an after-tax basis. Equity compensation strategies further utilize a deployment strategy of very gradually issuing the granted shares over time and rely on the growing profit distributions from previously purchased shares to help the minority owner address the tax costs associated with the grant. Finally, discounts for lack of control (for minority ownership interests) and lack of marketability (for ownership interests in privately-held companies), applied to the cash value of the shares can also be used to minimize the tax burden.

In sum, the granting or awarding of stock to one or more key employees can be an important part of a comprehensive succession planning and owner's level compensation strategy when used properly.

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