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Stock Grants vs. Stock Options
Common Mistakes For Cash-Poor Companies

by Theresa M. Mehringer

One common mistake of many small companies involves the company's attempt to "give an equity piece" by stock issuances to its employees or advisors after the founders stock is issued. Unfortunately, the company fails to take into consideration the tax effects of a stock grant issued in connection with the performance of services.

Here are the basic tax rules when dealing with stock grants. First, if you issue shares of stock to anyone, the recipient must pay fair market value (fmv) for the shares. If the recipient does not pay fmv value for the shares, then Section 83 of the Internal Revenue Code requires the recipient to pay tax on the difference between what the recipient paid (this is often $0) and the fmv of the shares. If the recipient is an employee, the fmv of the shares would be included in the employee's Form W-2, and withholding would apply just as if the employee received cash compensation equal to the fmv of the shares. If the recipient is an advisor (this would include non-employee directors), then the company is required to issue a Form 1099 reflecting the fmv of the shares, less any amount the recipient paid for the shares.

All of the discussion above might change slightly if the shares are subject to restrictions on transfer and a substantial risk of forfeiture (e.g., vesting). However, the restrictions on transfer and substantial risk of forfeiture merely delay the timing of the taxation to the employee. As the value of the stock increases, the amount of the tax payment due will increase accordingly. One method for minimizing the continuing increase in the tax payment, and for changing the character of the tax to be paid, is for the employee to make a Section 83(b) election under the Internal Revenue Code. This election requires the employee to pay tax at the time the shares are issued, despite the fact that the transferability restrictions and risk of forfeiture would otherwise delay taxation. However, as stated above, this requires cash to be paid to the IRS even though the shares may later drop in value. Further, the Section 83(b) election is irrevocable.

For smaller companies dealing with cash conservation issues, it makes no sense to issue shares that require immediate payment of taxes by both the company and the recipient. Rather, the grant of stock options under a stock option plan can accomplish the goal of the company being able to "give an equity piece" to recipients. Further, if the company is publicly traded and otherwise eligible to use a Form S-8 registration statement, the entire plan can be registered on the Form S-8 and recipients can control the timing of their option exercises and couple exercises with sales of their shares into the market to cover any resulting tax liability. A filing on Form S-8 is very simple, no SEC review is involved, and the S-8 becomes effective immediately upon filing with the SEC.

This is an overview of the most common issues relating to the issuance of stock for services that companies encounter. For a more detailed discussion of your company's situation, please contact me.