TAX IMPACT

September/October 2019

Tax implications of equity-based compensation

Take it or leave it?
How to handle your 401(k) plan when you retire

Filing a gift tax return regardless of whether it's required may be a plus

Tax Tips

Tax implications of equity-based compensation

Equity-based compensation is a powerful tool for attracting, retaining and motivating executives and other employees. By rewarding recipients for their contributions to your success, it aligns their interests with those of the company and provides them with an incentive to stay. Here's a look at some of the more common types.

Incentive stock options

Stock options confer the right to buy a certain number of shares at a fixed price for a specified time period. Typically, they're subject to a vesting schedule. This requires recipients to stay with the company for a certain amount of time or meet certain performance goals to enjoy their benefits.

Incentive stock options (ISOs) offer attractive tax advantages for employees. Unlike nonqualified stock options (NQSOs), ISOs don't generate taxable compensation when they're exercised; the employee isn't taxed until the shares are sold. And if the sale is a "qualifying disposition," 100% of the stock's appreciation is treated as capital gain and is free from payroll taxes.

To qualify, options must meet several requirements, including the following:

- They must be granted under a written plan that's approved by the shareholders within one year before or after adoption.
- The exercise price must be at least the stock's fair market value (FMV) on the grant date (110% of FMV for more-than-10% shareholders).
- The term can't exceed 10 years (five years for more-than-10% shareholders).
- They can't be granted to nonemployees.
- Employees can't sell the shares sooner than one year after the options are exercised or two years after the options are granted.
- The total FMV of stock options that first become exercisable by an employee in a calendar year can't exceed $100,000.

Although the benefits are substantial, ISOs also have drawbacks. Unlike NQSOs, qualifying ISOs don't generate tax deductions for the employer. In addition, there's a potentially significant tax risk for recipients: Employees subject to alternative minimum tax (AMT) — or whose exercise of ISOs triggers AMT — must pay tax on the spread between the exercise price and the stock's FMV on the exercise date, regardless of when they sell the stock. In other words, they're taxed on profits they haven't yet realized and may lose if the price declines later. (It may be possible to recover some or all of the tax in future years through AMT credits.)

Nonqualified stock options

NQSOs are simply stock options that don't qualify as ISOs. Typically, the exercise price is at least the stock's FMV on the grant date (to avoid tax complications that won't be discussed here). Also,

Equity compensation without the equity

Companies that aren't prepared to share equity with employees can still enjoy the benefits of equity-based compensation. There are several tools available that provide similar incentives — including vesting based on performance or years of service — without transferring stock (at least initially). They include:

Phantom stock. This is a bonus (usually cash but sometimes stock) based on the value of a stated number of shares at a specific point in time or upon a specified event.

Stock appreciation rights. They are similar to phantom stock, except that the bonus is based on the *increase* in the shares' value.

Restricted stock units (RSUs). These provide a contractual right to receive stock (or its cash value) once vesting conditions are satisfied.

Generally, these awards are treated as taxable compensation when an employee receives the bonus or, in the case of RSUs, the underlying shares.

in most cases, the NQSO itself isn't considered taxable compensation. Rather, there's no taxable event until the employee exercises the option. At that time, the spread between the stock's FMV and the exercise price is treated as compensation. It's taxable to the employee, deductible to the employer and subject to payroll taxes.

Even though NQSOs are taxed as ordinary income upon exercise, they have several advantages over ISOs. For one thing, they're not subject to the ISO requirements listed above, so they're more flexible. For example, they can be granted to independent contractors, outside directors or other nonemployees. Plus, they generate tax deductions for the employer and don't expose recipients to alternative minimum tax (AMT) risks.

Restricted stock

Another choice is to grant employees restricted stock — nontransferable stock that's subject to forfeiture until it vests (based on performance, years of service, or both). Restricted stock generally will retain at least some value even in volatile times, unlike options, which may become worthless if the stock's price declines below the exercise price.

Generally, the FMV of restricted stock is taxable to the employee (as ordinary income) and deductible by the employer when it vests. However, the employee can reduce the tax by filing an "83(b)" election to pay tax when the stock is received, converting all future appreciation into capital gains that aren't taxed until the stock is sold. But this strategy can be risky: An employee who makes the election and later forfeits the stock will have paid tax on income that was never received.

Review your options

If you're considering an equity-based compensation plan, it's important to review the pros, cons and tax implications of various approaches. If you're not ready to share equity with employees, there are tools available that tie compensation to stock values without transferring any shares. (See "Equity compensation without the equity" above.) ■

Take it or leave it?

How to handle your 401(k) plan when you retire

If you're newly retired, or planning to retire soon, you'll need to decide what to do with the savings you've accumulated in your company's 401(k) plan. If you don't need to tap the funds right away, it's generally best to let them continue earning investment income on a tax-deferred basis for as long as possible. But should you leave the funds in your employer's plan or roll them over into an IRA? As long as your account balance is $5,000 or more, you're permitted to keep your money in a former employer's plan.

Following are some of the factors to consider in making this decision. The discussion assumes that you have a traditional 401(k) plan account. If you have a Roth 401(k) account, different considerations may come into play.

If your 401(k) plan invests in the sponsoring employer's stock, consider the tax consequences of a rollover.

Investment options

IRAs offer a wider selection of investment options than 401(k) plans. Even if your company has carefully selected a menu of high-quality investments, your choices will likely be limited to 20 or 30 funds, while IRA owners may choose from among thousands of funds and individual securities. This makes it easier to build a well-diversified portfolio with an asset mix that's appropriate for your financial needs, risk tolerance and time horizon.

Fees and costs

Both 401(k) plans and IRAs generate fees and investment costs and, because they come out of your returns, they're easy to overlook. But these expenses can have a significant impact on the performance of your retirement funds, so do your homework. Often, it's possible to find an IRA with lower fees than your 401(k) plan, but in some cases it may be cheaper to leave your money in the plan.

Your age

Ordinarily, if you withdraw money from a 401(k) plan or IRA before age 59½, you'll owe a 10% penalty (in addition to taxes at your ordinary-income tax rate). There's an exception, however, that allows you to take penalty-free withdrawals from your former employer's 401(k) plan if you retire or otherwise leave your job when you're 55

or older. So, if you'll need to withdraw funds before you reach age 59½, it may be better to leave them in your 401(k).

Your work plans

If you're approaching age 70½, consider the impact of required minimum distributions (RMDs). Normally, you must begin taking taxable RMDs from 401(k) plans or IRAs when you reach that age. But suppose you're taking partial or phased retirement and will continue working for your employer part-time past age 70½? Some 401(k) plans allow you to postpone RMDs until the year you fully retire, so it may make sense to leave your money in the plan.

Company stock

If your 401(k) plan invests in the sponsoring employer's stock, consider the tax consequences of a rollover. If you roll over the entire balance into an IRA, future withdrawals will be taxed at ordinary-income tax rates. But if you leave the funds in your 401(k), you may have an opportunity to take advantage of favorable long-term capital gains tax rates.

Special rules allow you to spin off the company stock into a taxable account. (The remaining balance can then be rolled over into an IRA.) You'll immediately owe ordinary-income taxes on the stock's tax basis. However, all past and future appreciation will be treated as long-term capital gain when you sell the stock. Whether this strategy is right for you depends on the amount of appreciation, your tax bracket and your ability to pay the initial tax bill.

Take your time

When you retire or otherwise leave a job, there's no need to immediately withdraw your 401(k) plan funds. Take the time to review your options and consult your tax advisor before taking action. ■

Filing a gift tax return regardless of whether it's required may be a plus

Did you know that it may be advantageous to file a gift tax return when transferring property to a family member, even when one isn't required? If the return meets the IRS's "adequate disclosure" requirements, the three-year statute of limitations clock starts.

Avoiding future tax surprises

Generally, the IRS has three years to challenge the value of a transaction for gift tax purposes or to assert that a nongift was, in fact, a partial gift. But unless the transaction was adequately disclosed, there's no time limit for reviewing it and assessing additional gift tax. That means the IRS can collect

unpaid gift taxes — plus penalties and interest — years or even decades later.

There's a reluctance to file gift tax returns disclosing nongift transactions for fear of drawing the IRS's attention. However, a carefully prepared gift tax return can be the best insurance against unpleasant tax surprises down the road.

> ***If you file a timely gift tax return that meets the adequate disclosure requirements, the IRS has only three years in which to challenge the valuation.***

Define adequate disclosure

If you file a timely gift tax return that meets the adequate disclosure requirements, the IRS has only three years in which to challenge the valuation. To fulfill these requirements a return must include:

- A description of the transferred property and any consideration received,
- The identity of, and relationship between, the transferor and each transferee,
- The trust's tax identification number and a brief description of its terms (or a copy of the trust instrument) if property is transferred to a trust,
- Either a detailed description of the method used to value the transferred property or a qualified appraisal (see "Benefits of an independent appraisal" at right),
- A statement describing any position taken that's contrary to any proposed, temporary or final tax regulations or revenue rulings published at the time of the transfer, and
- An explanation as to why transfers reported as nongifts aren't gifts.

Additional requirements apply to transfers of interests in a corporation, partnership (including a limited liability company) or trust to a member of the transferor's family.

Other requirements

Adequate disclosure also requires a description of the transactions. This includes:

- A description of the transferred and retained interests and the methods used to value each,
- The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and *all parties related to the transferor holding an equity interest in any entity involved in the transaction*, and
- A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift (if any), including, for equity interests that aren't actively traded, the financial and other data used to determine value.

Financial data generally includes balance sheets and statements of net earnings, operating results, and dividends paid for each of the preceding five years.

Benefits of an independent appraisal

Obtaining an independent appraisal offers significant benefits, particularly for difficult-to-value property, such as interests in closely held businesses. An appraisal by a qualified appraiser helps ensure that the gift tax return contains all valuation information necessary to satisfy the adequate disclosure rules. Plus, if the appraisal is conducted at or near the time of the transfer, it will go a long way toward persuading the IRS that the original valuation of the property was accurate.

Speak to your advisor

In some cases, it's advisable to file a timely gift tax return that satisfies the adequate disclosure requirements. Contact your estate planning advisor for more information. ■

Tax Tips

Bonus depreciation for passenger automobiles

Under the Tax Cuts and Jobs Act (TCJA), businesses may claim an additional, first-year depreciation bonus equal to 100% of the depreciable basis of qualifying assets placed in service after September 27, 2017, and before January 1, 2023. The TCJA also increased the limit on bonus depreciation for passenger automobiles from $10,000 to $18,000.

An anomaly in the tax code, however, provides that, if a passenger auto's depreciable basis exceeds that limit, the excess isn't deductible until the first tax year after the end of the five-year recovery period, subject to a $5,760 annual limit. In other words, if your business acquires a $50,000 passenger auto in December 2019 and claims $18,000 in first-year bonus depreciation, it can't begin deducting the remaining $32,000 until 2025, limited to $5,760 per year.

To avoid this result, the IRS recently established a safe harbor accounting method that allows businesses to deduct the excess amount over the recovery period (subject to applicable limits). The safe harbor, which is available for autos placed in service before 2023, doesn't apply to businesses that claim Section 179 expensing for all or part of an auto's cost. ■

Minimizing taxes on trusts

If you've established or plan to establish one or more trusts as part of your estate plan, be sure to evaluate the tax implications. Trusts enter the highest tax bracket (37%) when their income tops $12,750, so it's important to consider steps to reduce the tax bite. Potential strategies include the following:

- Use grantor trusts. These trusts are designed so that the trust's income is taxed to the grantor, not the trust.
- Avoid taxable investments. Shifting the trust's investments to tax-exempt or tax-deferred investments, such as municipal bonds or life insurance, can reduce the burden of high income taxes.
- Distribute income. Generally, nongrantor trusts are taxed only on *undistributed* taxable income, which can be avoided if the trust distributes income to its beneficiaries.

Keep in mind that shifting income to the grantor or beneficiaries is effective only if they are in a lower tax bracket than the trust. ■

Donating stock to charity

If you're charitably inclined, consider donating appreciated stock, instead of cash, to charity. So long as you've held the stock for more than a year and itemize deductions on your tax return, you'll be entitled to deduct the stock's fair market value (up to 30% of your adjusted gross income). Plus, you'll avoid capital gains taxes that you would have paid had you sold the stock. The charity, as a tax-exempt entity, can sell the stock tax-free. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2019