KPMG

IPOs and equity compensation

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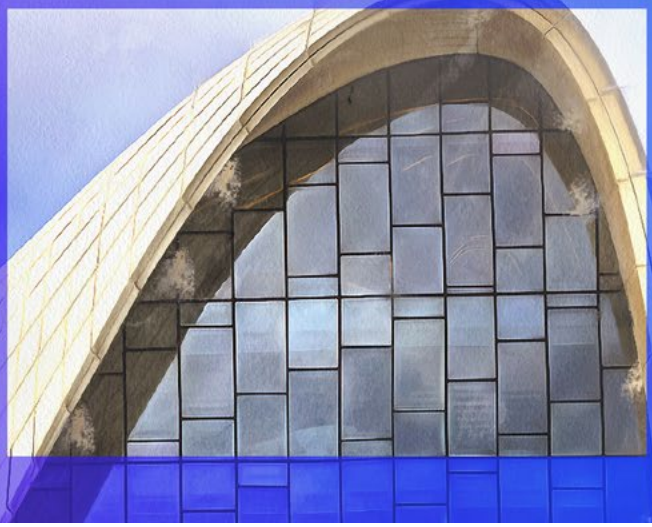


Tax issues require a greater focus for a public company for many reasons, including the potential impact on financial reporting and public disclosures. As such, companies preparing for an initial public offering (IPO) must be aware of common tax issues that could arise and establish a framework to be compliant. We discuss some of the common tax issues for private companies below and provide some practical insights.

1 Stock valuation issues prior to the IPO – Stock options and other stock-based compensation

Stock options subject to section 409A typically do not comply with the section 409A requirements resulting in the application of immediate income inclusion (upon vesting) and significant additional federal (and sometimes state) income tax. To be exempt from section 409A under the stock rights exception, one of the requirements is that the stock option must have an exercise price no less than the fair market value (FMV) of the underlying stock on the date of grant. For purposes of determining the FMV of the stock, nonpublic corporations typically rely on the regulatory provision providing a rebuttable presumption that the FMV as determined by an independent appraisal is the FMV of the stock. While the presumption generally is available for up to 12 months following the effective date of the appraisal, the presumption may be lost during the run-up to an IPO if the use of the appraisal becomes "grossly unreasonable" due to subsequent events making it clear that the appraised value has become too low.

KPMG insight: Notably, although nonpublic corporation employers often use the 409A valuation for purposes of determining the compensation paid upon the exercise of a stock option, in contrast for a section 83(b) election or vesting of restricted stock, and the delivery of restricted stock units (RSUs),the rebuttable presumption related to a section 409A valuation doesn't apply for these purposes. Therefore, for these wage payment dates the employer must take into account whether the 409A valuation may still be defended as reasonably representing the FMV of the underlying shares.

2 RSUs and IPOs

Employers often arrange for RSUs to be paid out as part of an IPO, with the intent of measuring the compensation and wages based on the initial or targeted IPO offering price. This will require lining up the RSU payment date to be able to use the FMV immediately prior to the IPO, or the IPO opening price, as the FMV of the shares. Once the stock is publicly traded, the determination of the FMV must be based on the exchange trading price. This may be the opening price or closing price on the date of grant, a reasonable average based on trading prices on the date of grant, or the closing price on the day before the grant. For RSU payments and an IPO, this limits the use of the IPO initial opening price to payments made no later than the date of the IPO; after that date, the market price may diverge, and any change must be reflected in the valuation of the stock for purposes of calculating the amount of the wage payment. (Note that another alternative is to vest the RSUs prior to the opening of the market and use the FMV based on a valuation, typically the target price for the IPO). For this purpose, the payment date for purposes of valuing the stock and determining the amount of the wage payment is not necessarily the date the shares settle in the employee's account, but rather the date the employer "initiates the payment of the shares," which may be on an earlier day (but see below regarding how the settlement date may affect the application of the employment tax deposit rules).

KPMG insight: In practice, the settlement process upon IPO needs to be in alignment with the date of vesting of awards and the date of initiation of payment, to enable the use of the IPO target price or opening price and for purposes of the deadlines for the next-day deposit rules in the US. In addition, alignment with the stock plan administrator and transfer agent of the shares is important particularly when the company may be changing vendors as part of the IPO. Often the dollar value of awards vesting on an IPO is significant, resulting in substantial amounts of employment tax payments subject to the next day deposit rule, so planning should take into account the need for significant cash funds to be available.

3 RSUs, employment taxes, and lock-up periods

An IPO typically is followed by a temporary lock-up period during which employees are not able to sell their shares. Some employees may assume that this will result in a delay of the taxation of the compensation, but this assumption would be incorrect. A temporary lock-up period is a "lapse restriction" under section 83 of the Code, meaning that it does not stop the taxation of the transfer of the stock and it cannot be considered for purposes of determining the FMV of the stock transferred. This also means that the employment tax withholding and deposit requirements will not be delayed, so that the employer will need to determine the source of cash to pay the deposits. Withholding may occur through share withholding (meaning the withholding is applied through a reduction in the number of shares delivered to the employee, a/k/a "net settlement") but the employment taxes still must be deposited in US dollars so in that case the employer must determine the source of the cash and whether any shares may be sold in compliance with the lock-up period to fund the tax payment. Withholding may also be accomplished by withholding additional amounts on other wages paid simultaneously to the employee, or having the employee pay the withholdings to the employer directly (which in both cases would allow the employee to keep all the shares payable under the RSU but may also not be popular with employees from a cash flow perspective). But the employer typically will not be able to delay the tax deposit which in most cases will be subject to the next day deposit rules because federal employment taxes in excess of $100,000 will accrue on the RSU payment date. Depending on the settlement date to the employee's accounts, the applicable IRS relief may provide one additional day for the employer to make the deposit, but that is the extent of any permissible delay. (KPMG understands that the IRS will be updating the applicable relief to take into account the shortening of the Securities and Exchange Commission SEC settlement rule from T+2 to T+1.)

KPMG insight: In practice, net settlement upon an IPO will be a cash drain on the company because it will need to fund the cash equivalent of the netted shares and remit the applicable taxes in all jurisdictions to the local tax authorities in accordance with the applicable foreign payroll deadlines. We often see companies switch to alternative withholding methods after the IPO event to manage cash flow such as sell to cover. Another alternative is to structure the RSU or other equity plan to deliver shares only six months after the IPO (although that may mean post-IPO appreciation will be treated as compensation). Investors are also becoming increasingly willing to release some portion of shares otherwise subject to the lock-up period solely to cover the sale of shares to cover employment tax obligations.

4 Supplemental wage withholding

Whether as stock-based compensation or IPO cash bonus payments, the compensation payable due to the IPO often will be supplemental wages, meaning wages not paid as regular wages (e.g., salary), and so subject to different federal income tax withholding rules. For supplemental wage payments made before the employee has received more than $1 million in supplemental wage payments for the calendar year and that do not cause the total supplemental wage payments to an employee to exceed $1 million for the year, the employer generally may choose to use a 22 percent supplemental withholding rate. This is popular with employers because it simplifies administration of payments, particularly payments made in stock, which may not be incorporated directly into the standard withholding process and lowers the amount of cash that must be sourced for the deposit. But this may be unpopular with certain employees who wonder if this will result in additional tax payments either as part of the Form 1040 due on April 15 of the next year or even in estimated tax payments due before that date. As a result, many platforms have begun offering employees elective "additional" federal income tax withholding. Although the IRS has stated that there is no authority to apply the additional federal income tax withholding outside of the Form W-4 process, the IRS hasn't stated what penalties would apply or how any penalties would be calculated given that in the case of additional withholding, additional taxes have been paid and early.

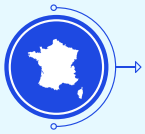
In contrast, if the employee has already received more than $1 million in supplemental wage payments for the year, the employer must apply withholding at the maximum rate (currently 37 percent). For a payment that causes the supplemental wage payments for the year to that employee to exceed $1 million, the employer may choose to apply the maximum rate to the entire payment or to only the portion that exceeds $1 million for the year. Because some employees may have tax situations under which a 37 percent withholding would be beyond what would apply to regular wages, employees should be provided notice of the withholding and that they will be able to recover those withheld amounts as credits in the Form 1040 income tax process.

KPMG insight: In practice, many companies do collaborate with senior executives to withhold at higher rates to help them manage their financial situation often referred to as a "white glove service," where the company typically requests a written confirmation for each transaction in case of a future audit. To date the IRS has not been known to challenge overwithholding, only underwithholding. Note also that this still ends up being a cash drain on the company, as for executives, the company must find in cash the higher share withholding amount elected by the executive.

5 Coordination with non-US jurisdictions

In an international context in which employees with stock-based compensation reside in multiple jurisdictions, there will need to be coordination across the tax rules of all applicable jurisdictions. Similar to the treatment in the US, each jurisdiction may have its own process including some relatively idiosyncratic results. Here are some illustrative examples of the impact an IPO may have on equity awards vesting in international jurisdictions:

United Kingdom—There can be situations resulting from the IPO in which, based on the employee's particular tax code, the effective marginal tax rate is higher. For example, taxable income of between £100,000 and £125,140 can have an effective tax rate of 60 percent due to the withdrawal of the personal allowance in the UK. This could mean the sell to cover withholding is insufficient to cover the entire tax and employee national insurance contributions (NIC) arising on an RSU vesting and payment, which could impact the employee's net salary. Because the value of vested and paid RSUs increases an employee's overall employment income for the relevant tax year (running April 6 to April 5), it could also have other personal tax implications for the employee for example triggering additional student loan repayments or loss of government funded childcare support because "adjusted net income" increases above £100,000. Thus, a one-off equity vesting in a particular month can trigger student loan repayments, which require employer withholding. Note the employer cannot choose to opt out of performing withholding on the student loan repayments. In addition, the equity plan provisions may not permit the employer to withhold additional shares for student loan repayments, and this could result in employment law considerations.

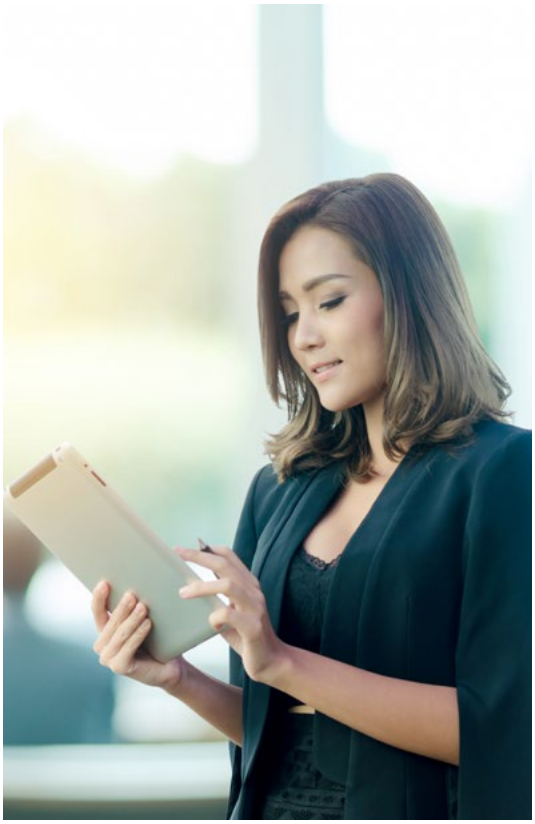


France—The IPO event could mean that the required holding periods for RSUs in France could be shortened, thereby resulting in the loss of tax qualified treatment, creating an additional tax burden for employees. If this occurs, then best practice is to notify employees in advance and manage around the change.

KPMG insight: It is critical to perform a tax and regulatory diligence of the impact of the IPO upon outstanding awards outside the US to identify adverse tax consequences that may arise. Such issues would need to be managed well before the IPO event and appropriate advance communication with impacted employees is important.

6 Treatment of ISOs

The treatment of any outstanding incentive stock options (ISOs) under section 422 may reduce Federal Insurance Contributions Act (FICA) taxes. An ISO offers the opportunity to avoid compensation income if the stock is held for the required holding periods—two years from the date of grant and one year from the date of exercise. But in the context of an IPO, this may not be available since the holding periods may not be met if the employee sells the stock as part of the IPO. If the intent is for employees to participate in the IPO, then the employer may face the decision of whether to cash out the ISOs heading into the IPO or instead have the employees exercise and participate in the IPO. If an ISO is actually exercised, meaning the shares are issued to the employee, then neither the exercise to purchase the stock nor the subsequent sale of the stock is subject to FICA tax. The sale of the stock will be a disqualifying disposition, meaning a sale that did not meet the ISO holding periods, which will need to be reported on the Form W-2 as compensation income but is not subject to federal income tax withholding (or FICA taxes). In contrast, a cash-out of an ISO without an actual exercise will be treated similarly to the cashout of a nonstatutory stock option—the payment will be wages reportable on the Form W-2 and subject to federal income tax withholding and FICA taxes.



KPMG insight: A critical factor here is the decision around cashing out versus settling awards in stock as this could also result in additional taxes being due in certain countries, e.g., if cash settlement would trigger employer tax withholding and/or employer and employee Social Security taxes in some jurisdictions. A review of these rules would be needed to assess the impact of this decision globally. In addition, the employer would experience a cash drain to fund a cash-out versus allowing employees to exercise.

7 Application of the section 162(m) deduction limitation

The deduction limitation of section 162(m) will apply for the entire corporate taxable year that includes the IPO. Section 162(m) generally provides that a public corporation may not take a deduction with respect to compensation in excess of $1 million paid to certain covered employees. For this purpose, a covered employee includes the chief executive officer (CEO), the chief financial officer (CFO), and the three highest-compensated officers who are not the CEO or the CFO (and once an individual is a covered employee for a taxable year, he or she remains a covered employee for all subsequent years including years after termination of employment [postretirement] and even after death in the case of death benefits). Starting in 2027, the scope of covered employees expands to add the five highest-compensated employees during the year (regardless of whether the employee was a corporate officer), though for these additional five employees the permanent status as a covered employee rule does not apply. With respect to the identification of the five highest-compensated employees, including their relationship to employees already identified as covered employees under the current rule, corporations continue to wait for regulatory guidance from the IRS.

A corporation is a public corporation if the corporation has either publicly traded stock or debt on the last day of its taxable year, in which case the deduction limitation applies to the entire taxable year. That means that there is no proration based on whether the services were provided, or the compensation paid, during the tax year but prior to the IPO. Rather, all deductions for that tax year with respect to compensation of covered employees will be subject to the deduction limitation.

KPMG insight: The list of covered employees for whom compensation will be subject to the section 162(m) deduction limitation will include any person serving as CEO or CFO during the taxable year of the IPO, and in determining the highest-compensated officers will take into account any individual serving as an officer during the taxable year and their compensation for the entire taxable year even if the officer is not employed on the last day of the taxable year. Once on the list of covered employees, the individual will remain a covered employee even if the individual is no longer serving as CEO or CFO or as one of the highest-compensated officers in future years (or even continuing as an employee). If there have been personnel changes as part of the run up to the IPO, or there are intended to be personnel changes after the IPO, then the corporation may want to see whether any steps may be taken to minimize the ultimate number of employees added to the list of covered employees as part of the IPO process.

8 Deductions–Recharging and other international issues

With an upcoming IPO, companies will want to maximize corporate tax benefits available across all jurisdictions for employee equity awards. While corporate tax deductions rely in most countries on the existence of a recharge agreement between the parent and the local employing entity, many companies leave tax deductions on the table for equity compensation earned by mobile employees. If there is a significant mobile employee population, then the corporate tax deductions typically mirror the amount recognized as income in each jurisdiction during the grant to vest period. While there are some exceptions, the company may benefit from an analysis of expected tax deductions upon IPO for this category of employee. This is relatively simple to calculate if the mobile employee data and award data are already being used to calculate trailing tax liabilities.

KPMG insight: The invoicing of equity award costs in the current tax year in international jurisdictions should be aligned with the timing of the IPO, to capture corporate tax deductions on a sourced basis. A review of the language of the recharge agreements is also needed to help ensure the calculation of the recharge amount includes split deductions based on the number of jurisdictions in which the employee performed services during the grant to vest period, to the extent deductions are permissible across those jurisdictions.

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