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How Your M&A Deal Treats the Payout of Employee Stock Options Can Have Significant Payroll Tax Implications

When an M&A deal is structured such that the target company's employee stock options will be "cashed out" or automatically deemed "net exercised," it can result in the payment of substantial payroll taxes by both the buyer and the employee that may have been avoided. There are numerous ways to handle employee stock options, all of which have varied tax consequences. For each treatment, it is important to understand the unique tax implications, as well as how those laws may be used most favorably for the participants involved. Additionally, understanding ideal treatment of an Incentive Stock Option (ISO) as well as structuring flexible plans can offer a solid solution for buyers and employees resulting in positive tax benefits.

Tax Requirements for ISOs

No federal income tax withholding and no Federal Insurance Contributions Act (i.e., Social Security and Medicare or, FICA) taxes or Federal Unemployment Tax Act (FUTA) taxes apply to the exercise of an ISO or the sale of exercised shares from an ISO. Most states follow the federal tax treatment of stock options (Pennsylvania is one noted exception). This treatment is afforded to ISOs even if the employee exercised the ISO and sold the ISO shares on the same day, resulting in a disqualifying disposition. A disqualifying disposition occurs if the sale of the ISO shares takes place before two years from the date on which the ISO was granted or one year from the date on which the ISO was exercised. Regardless of when the ISO was granted, the immediate sale of exercised ISO shares in an acquisition will fail the second test. The disqualifying disposition of an ISO results in compensation income reportable on W-2, but income and employment tax withholding is NOT required and that income is never subject to FICA or FUTA taxes. Since the buyer would otherwise have to pay the employer match portion of FICA taxes (plus the FUTA taxes) on the FICA taxes paid by the employee, avoiding this withholding can result in substantial savings to both the buyer and the employee. The buyer would also avoid the additional reporting burdens that come with payroll withholding and remittance.

“Cash-Out” Payment

Often, a target company's equity incentive plan gives flexibility to the board to provide a “cash out” payment to participants holding stock awards that will terminate if not exercised prior to a corporate transaction, rather than forcing such participants to actually exercise. In that case, the participant would receive a payment equal in value to the excess of: (a) the value of the property the holder of the stock award would have received upon exercise of the stock award, over (b) any exercise price payable by the participant in connection with such an exercise. Then this mechanism becomes part of the acquisition deal structure and results in the “cash out” of all options. Unfortunately, this assures that both the buyer and the employee will unnecessarily pay employment taxes on the proceeds to all ISO holders. Under IRS regulations, cashing out an ISO does not involve the exercise of the ISO, so income and employment taxes have to be withheld from the proceeds of the cash-out.

Net Exercise

Similarly, although the issue of ISOs and net exercise is subject to some debate, the prevailing view is that the use of net exercise for an ISO disqualifies the entire grant from preferential tax treatment. Under a “net exercise” arrangement an option holder can, rather than pay the exercise price, instruct the company to issue a net number of shares after deducting the number of shares equal in value to the aggregate exercise price. However, the ISO rules require the option holder to pay the exercise price by tendering either cash or company stock (i.e., currently owned company stock). Merely tendering the option in exchange for stock equal to its value will produce the same result as a nonqualified stock option. Because of this, net exercise or stock appreciation right features are not available for the exercise of an ISO under many plans and are offered only for nonqualified stock options (NSOs). Regardless, if the acquisition terms provide that options will be deemed net exercised at closing and paid based on the net number of shares owned, that will cause any ISOs to be treated as NSOs and the proceeds paid will be compensation income subject to all income tax and employment tax withholding.

The Benefit of Issuing ISOs to Employees

To be sure, the ability to avoid payment of employment taxes is available only to the extent the target company has granted ISOs to its employees. If, for example, a target company has used only NSOs, restricted stock units, or stock appreciation rights as equity incentives to employees under its plan (and not ISOs), then this favorable tax treatment is not available, regardless of how such awards are treated in the deal. Also, only employees are eligible to receive ISOs, not consultants, independent contractors, or board members. Of course, income and employment tax withholding does not apply to non-employees, so there is nothing to avoid with respect to payments to such non-employee holders, regardless of what type of equity incentive they hold.

The Importance of Flexible Acquisition Plans

For this reason, a well-drafted plan should be flexible in how options may be treated in an acquisition. In a flexible plan, options do not need to be treated uniformly. The board can determine at the time of the transaction whether outstanding options should be: (1) cancelled at the time of the acquisition, if not previously exercised or, (2) cashed out in exchange for a cash payment equal to the difference between the exercise price of the option and the price per share of the underlying stock to be received in the transaction (i.e., “in the money” options). In a cash transaction, it would be most desirable to cancel “out of the money” options for no consideration and provide for a cash payment to “in the money” options that are not ISOs. ISOs should be subject to the first option – i.e., all outstanding ISOs would be cancelled if not exercised at the closing of the transaction.

Ideal Treatment of ISOs

Requiring all ISOs to be exercised would force the disqualifying disposition of all “in the money” ISOs, thereby avoiding the income and employment tax withholding requirements with respect to all proceeds paid to employees who held ISOs. Logically, holders of “out of the money” options would not exercise and would let the ISOs cancel. Since the buyer also benefits from avoiding these withholding requirements, the buyer may require this treatment as part of the deal structure and insist that the target company amend its plan as necessary to accommodate such (if the plan isn’t already drafted for that flexibility and subject to confirming no negative IRC Section 409A ramifications).

Treating ISOs in this manner should have no adverse effect on the employee ISO holder. The holder can submit the exercise price contingent upon the deal closing, at which time he or she will receive payment of closing proceeds from the transaction, which will more than cover the exercise cost. In addition, although the alternative minimum tax (AMT) can apply when an ISO is exercised, AMT does not apply if the exercised ISO shares are sold in the year the options are exercised. Obviously, if an ISO holder exercises and immediately sells the exercised shares to buyer in connection with an acquisition transaction, the shares are sold in the same year as exercise.

Conclusion

Given the substantial benefits to the buyer and employees of companies that have granted ISOs, buyers should consider structuring their acquisition to provide that ISOs will be canceled if not exercised at closing, rather than default to a blanket cash-out approach. Consciously dictating the disqualifying disposition of all ISOs can maximize the preferential tax treatment available to buyers and employees.

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