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Incentive Stock Options May Not Be All That They Seem

Equity is an important compensation tool for employers to create alignment, incentivize performance, build long-term value, and control the cash cost of compensation.

There are several types of equity compensation arrangements, each with different economic and tax attributes that can influence how and when they are used. Depending on the situation, some arrangements can favor the employer over the employee, and some the employee over the employer. The tax implications of incentive stock options (ISOs) can vary dramatically depending on how and when an employee exercises and monetizes an award.

Once a popular equity compensation arrangement, ISOs have decreased in relative popularity since the early 2000s in favor of restricted stock arrangements and non-statutory stock options (NSOs). However, in today's market ISOs are increasingly being utilized by venture or private equity-backed private companies. With this rise in use, it is important to understand the complexities and issues faced by employees exercising and monetizing ISOs in today's acquisition-focused environment.

Potential Benefits

The tax treatment of an ISO is typically beneficial to an employee relative to other equity compensation arrangements. Unlike ISOs, both NSOs upon exercise and restricted stock arrangements upon vesting generally create taxable compensation to the employee subject to income tax, social security and Medicare tax withholding. Conversely, with ISOs there is no taxable compensation to the employee provided that the employee holds the shares received upon exercise for at least two years after grant and one year after exercise. Employees meeting the above requirements are taxed at federal long-term capital gains rates (generally 23.8% including the net investment income tax) when the shares are monetized after being held for more than one year. Due to this favorable rate, employees generally prefer ISOs. However, several other complex and often overlooked issues can arise with respect to ISOs that negate potential benefits to the employee.

Potential Drawbacks

One consideration with respect to ISOs is the alternative minimum tax (AMT). ISOs can have significant AMT implications that are often misunderstood. While the 2017 tax reform repealed the AMT for corporations, AMT remains in effect for individual taxpayers. While the exercise of ISOs does not generate taxable compensation for regular tax purposes, the spread between the fair market value of the stock and the exercise price on the date of exercise generates taxable income for AMT purposes, potentially subjecting the employee to AMT of 26% or 28% in the year of exercise.

Aside from this rather mechanical AMT issue, several common corporate events can contribute to a loss of the beneficial tax treatment of ISOs. Often, employees exercising ISOs end up disposing of the shares in a disqualifying disposition (a disposition less than two years from the grant date and less than one year from the exercise date) because the option exercise is done in connection with the sale of the business. Similarly, employees may receive an option termination payment of cash in lieu of exercising the option as part of a sale transaction. In these scenarios the employee will recognize compensation income. In addition, an option termination payment (but not a disqualifying disposition) is also subject to FICA taxes.

Another often misunderstood and complicating factor of ISOs is the annual $100,000 aggregate value limitation. Under this limitation, the amount of options that qualify as ISOs is based on the exercise price times the number of options that become exercisable for the first time in a calendar year. If the aggregate value of ISOs that first become exercisable in any year exceeds $100,000, the excess options are treated as NSOs. Those employees receiving large grants, or grants in the middle to later stages of venture or private equity ownership when share values may be higher, tend to exceed this limitation for part or most of the ISO award. Furthermore, many ISO awards contain an early exercise provision which allows the employee to exercise all the options at any time for tax purposes, even if the options are subject to vesting over time under the award. When early exercise provisions are present starting at date of grant, the options are treated as exercisable immediately upon grant, and the $100,000 limitation is applied at that time to the entire award. Many employees may not realize part or most of the ISO grant is immediately classified as an NSO, potentially leading to surprise at the time of exercise or when they receive a Form W-2 at the end of the year reporting the taxable ordinary income. Also note, the acceleration of vesting may also cause ISOs to be treated as NSOs.

Early exercise features can be common, because an employee may be able to mitigate AMT by making a Sec. 83(b) election (for AMT purposes) when the value of the company is currently low, but expected to grow quickly, and can reduce the potential impact of a disqualifying disposition in the event of a sale. However, a Sec. 83(b) election carries additional risk, as there is more uncertainty regarding the company's prospects early in its life cycle with respect to the employee's capital that is now at risk (strike price and AMT liability paid), compared to no capital at risk in holding the ISO until the employee has more visibility into the company's future.

The Takeaway

Incentive stock options may seem like a great choice to provide employees with incentive to grow long-term value and enjoy beneficial long-term capital gains tax rates upon disposition of the shares. However, in today's transaction-focused environment, employees holding ISOs often do not meet the holding period requirements, resulting in disqualifying dispositions or option termination payments that generate ordinary income. Furthermore, the AMT impact and complexities such as the $100,000 annual limitation can also negate some of the tax benefit of these arrangements. Employers must take these considerations into account given the specific factual situation of their business when evaluating equity compensation arrangements. After such considerations, ISOs may prove to not be what was intended.

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Considerations of Private Equity Fund Clawback Liability

As previously discussed in Structuring a Carried Interest, funds will often grant an interest in profits known as a carried interest to its general partner (GP) in order to incentivize the GP to maximize profits overall.

The form of carried interest can vary widely, but generally will fall into one of two structures: first, it can be accrued on a deal-by-deal basis; or second, it can be based on the performance of the entire fund. This article discusses how clawbacks work in the context of private equity carried interest and discusses some ways to avoid or manage clawback liability.

How Do Clawbacks Work?

When a fund allows for a carried interest, a common provision in the agreement is for a clawback from the GP. In essence, if the GP receives a distribution against its accrued carried interest that it ends up not being entitled to (often for failing to meet certain performance levels), the GP must return it to the fund so that it can be allocated back to the limited partners (LPs). Effectively, it serves as a deficit restoration obligation (DRO) for the GP in the event that its book capital account is negative.

For example, assume a fund calculates a 20% carried interest based on overall performance. In the first year, the fund has unrealized gains of 100, and accrues a carry of 20 to the GP. The GP then takes a distribution of that 20 as cash. In the second year, the fund has an unrealized loss of 100. Inception to date, the fund has no profit, and thus the GP is entitled to no carried interest. However the GP has already taken a distribution of 20. If the fund liquidates with no further gains, a clawback provision protects the rights of the LPs to receive that cash back.

The Decision to Incorporate a Clawback

There is no requirement for a partnership to have a clawback provision in its agreement. Partnership allocations are however required to have substantial economic effect, and one component of that is a DRO, which is a required obligation by a partner in a partnership agreement to restore any deficit (positive or negative) balance in their capital account when the partnership liquidates. A DRO can mirror a clawback provision for a GP since any partner with a negative book capital account upon liquidation would be required to make a contribution at least equal to the deficit. But even a DRO is not necessarily required if a partnership meets an alternative test for economic effect, such as a qualified income offset. Ultimately, it is up to the fund manager to decide how the fund should operate and whether to incorporate a clawback provision. If an LP investing in a fund wishes to protect its interest, it would either need to confirm that a clawback exists in the agreement, or request it prior to signing.

How to Manage or Avoid a Clawback Liability

Limits on Distributions

At its simplest, a fund can avoid any possibility of a clawback (whether required by the agreement or purely from an investor relations standpoint) by making no distributions to the GP until it is absolutely certain the GP is entitled to a carry. This is perhaps easiest in a deal-by-deal structure, where the economics of a particular deal, and thus the carried interest calculation, are certain at its completion. Similarly, a hedge fund calculating a carried interest on a quarterly basis should be able to determine the carry at the close of each period. But where a carry is based on the overall performance of the fund since inception, it may not be possible to be certain how much carried interest the GP is entitled to until liquidation.

This simple case however, is unlikely. Even if the GP wishes to avoid taking distributions of carried interest until the calculation is certain, it will still likely receive ongoing allocations of taxable income based on the accrued book carry. Tax allocations to the GP cannot simply be made upon liquidation when the carry is determined and distributed since there may not be enough taxable income during the year to allocate for the carry in full. The GP will likely receive allocations as income is recognized, meaning that the GP will likely want tax distributions, if nothing else. Tax distributions are not apart from the carried interest; they are, in fact, debited from the GP’s capital account, and reduce any future carried interest distributions. If the GP is ultimately entitled to less carry than the tax distributions it received inception to date, and if the agreement contains a clawback provision, the GP would be required to pay back its tax distributions whether or not it receives a tax benefit for losses allocated in later years.

Balance Competing Interests

Since there is no requirement for a clawback provision, funds have flexibility to write them in ways that balance the competing interests of the GP and LPs. While LPs may insist on a clawback, the GP may be able to negotiate a cap on the amount, such as a clawback only for distributions in excess of the GP's tax liability. The GP should also plan for some amount of liquidity, either itself or from its members, just in case there is a clawback. If a manager feels that one or more members would be unable to recontribute a clawback obligation to the fund, it may wish to require that cash is put in escrow, or simply not distributed out of the GP until a particular event.

Fund Capitalization

The GP can also avoid or mitigate a clawback through a fund capitalization, which generally occurs near or after the term of the fund. While a fund is winding down, the GP may decide to continue to manage its remaining investments which can be accomplished by creating a new fund. The remaining assets of the existing fund will be sold or contributed to the new fund along with new buyer capital. Investors of the existing fund may have the option to sell their interest or roll it over into the new fund either on existing fund terms or new fund terms. New investors can: 1) purchase interest from existing investors who choose to sell or 2) commit to additional capital for add-on or new investments. Meanwhile, the GP generally will be required to roll over its interest in the existing fund to the new fund.

The fund capitalization described above allows for a greater time period for the GP to earn carry and potentially reduce or eliminate the clawback liability. The clawback related to the investors that cashed out from the existing fund will have settled with the new investor capital. Investors that choose to roll over into the new fund may be willing to re-set the valuation over which carried interest distributions are payable, factoring in any clawback amount. From a tax perspective, under this scenario there is no tax gain or loss to report at the GP level. The GP's tax basis in the existing fund will be carried over to the new fund, which should be close to its equity investment. The GP would have received tax income allocations close to carried interest distribution in year(s) distributed causing little to no change in basis. It is important to note that a fund recapitalization offers multiple potential upsides with clawback flexibility merely being one of them.

Timing

Another consideration is the timing of the clawback liability. Generally, the clawback liability is applied once at or near the end of the fund's term when there is no additional carried interest expected. For their own benefit, however, LPs are more likely to request interim clawback test dates from the investment period through the end of the fund term. Periodic testing can help mitigate clawback obligations. If testing shows there may be an obligation, the fund can prevent future distributions to the GP. Additionally, the fund should make the clawback calculation if there are only straggler investments since there would be no additional carried interest at that point. These investments could delay the liquidation of the fund or even cause the fund to extend the term, which could cause tension amongst the LPs.

The Takeaway

The handling of the clawback provision, or lack thereof, and how the obligation is paid can be a source of conflict between the LPs and the GP. To ease this tension, it is important when a fund is created to discuss clawback obligation details and for the partnership agreement to include proper provisions, if applicable, that meet both the LPs and GPs' expectations.

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Tax Reform Impacts on Hobby-Related Deductions

One provision of the Tax Cuts and Jobs Act of 2017 (TCJA) that has received much attention is the suspension of miscellaneous itemized deductions subject to the 2% of adjusted gross income limitation for tax years beginning in 2018. However, what has not garnered much attention is that this provision could create highly adverse tax consequences for taxpayers with income-generating hobbies.

Under general tax principals, taxpayers who are engaged in a trade or business may deduct their ordinary and necessary business expenses when computing their taxable income. If there are excess expenses, this net loss can, at least to a certain extent, offset other non-business income. However, the law does not allow taxpayers to treat their hobbies as businesses in order to get the tax benefit of expenses relating to those hobbies. In fact, under the new law, NONE of a taxpayer's hobby expenses are deductible. As a general rule, the law frowns upon activities that are not engaged in for profit —and there are rules IRS uses to try to find and tax those enterprises. Consider the following fact patterns:

Taxpayer 1 has a farm and raises horses. She loves to ride and approaches her enterprise as a hobby. She has room to let a few people board their horses in her barn for a fee and she has fields that she allows others to mow for hay which she sells. This small income typically around $42,000 per year helps offset her costs. This income typically totals $2,000 per year. Because her costs in operating the farm are so high, she has never paid attention to reporting the income.

Taxpayer 2 is independently wealthy. He rents some retail space in town and operates a bookstore as a sole proprietorship. He loves books, loves interacting with people who like to read and enjoys coming to work every day. Though he sells some books his income never covers all the costs and it never will—but he doesn't care. He reports the income and expenses on his tax return, showing a small loss that shelters other income.

Finally, Taxpayer 3 and 4 share a passion for old furniture that they find, refurbish and sell. Their friends appreciate their fine craftsmanship and often ask for their help with certain pieces. They both have jobs and readily acknowledge that the business is first and foremost for fun. Since they are conservative with respect to tax matters they have always roughly limited their expense deductions to their income from the business. Last year, they sold $20,000 of furniture that they purchased for $1,000. However, their costs to repair and refurbish the pieces were $22,000. They only deducted $19,000, showing no net income and no loss.

Before 2018, all of the above taxpayers could deduct their expenses up to the amount of their hobby income and to the extent those expenses exceeded 2% of their adjusted gross income. These deductions helped minimize any tax that needed to be paid associated with the income. Under the TCJA, these expenses are no longer deductible. Instead, they now have to report their income and are allowed NO deduction for their expenses. In the above examples, now Taxpayer 1 must report and pay tax on her $2,000 of income, Taxpayer 2 must report all his book income (although he can he can deduct any cost of buying the books he sells), and Taxpayers 3 and 4 must report $19,000 of income and can deduct none of their expenses.

The Takeaway

It is not uncommon for taxpayers to operate enterprises that forever lose money. If those enterprises are deemed by IRS to be hobbies, then the results described above will happen to these taxpayers While there are guidelines published by IRS for determining whether a taxpayer is running a hobby or a business, there is often much gray area. Taxpayers who have a potential for this risk should consult with their tax advisors about the nature of their risk and what can be done to manage or mitigate that risk going forward.

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Export Tax Incentives: IC-DISC, FDII or Both?

Prior to the enactment of the Tax Cut and Jobs Act (TCJA), the Interest-Charge Domestic International Sales Corporation (IC-DISC) was the only remaining export tax incentive after the repeal of the foreign sales corporation and extraterritorial income rules. The TCJA introduced a new export tax incentive, the Foreign-Derived Intangible Income (FDII) deduction.

Whether a taxpayer can or should utilize one or both of the export tax incentives is a complicated and highly fact-specific analysis. This article provides an overview of the export tax incentives, eligibility requirements and the overlap between the two.

IC-DISC Overview

An IC-DISC is a domestic C corporation that has made an election to be taxed as an IC-DISC, subject to easily managed administrative rules. IC-DISCs are not subject to federal income tax on qualifying export income. Qualified export income is income derived from the sale of qualified export property (defined below). Instead, the IC-DISC's shareholders are subject to tax when dividends are paid or deemed paid to them. If the shareholders are ultimately individuals, trusts or trust beneficiaries (i.e., not a C corporation), then corporate level tax may be avoided altogether, and the taxable income would consist solely of dividends paid to those shareholders or beneficiaries.

For C corporation shareholders, this dividend income (and double layer of tax) can be deferred by issuing producer loans or factoring foreign trade receivables. Factoring receivables is the process of purchasing account receivables at a discounted price and later collecting the full amount of the receivables at a profit. In addition, if closely held, a C corporation that pays dividends to its shareholders can claim a federal tax deduction for a portion of those dividends in the form of a commission deduction when utilizing an IC-DISC owned by those same shareholders.

A commission IC-DISC provides sales and export related services to a related party supplier and is paid a commission for those services. The commission is the higher of 4% of qualified export gross receipts (defined below) or 50% on the net income from the sale of export property. The related supplier can also claim a tax deduction for the commission paid. A buy/sell IC-DISC purchases export property for resale outside the U.S., resulting in 100% of the net income qualifying for benefits.

Export property is qualified property that is manufactured, produced, grown or extracted in the U.S., and is held in the ordinary course of business for use, consumption and disposition outside of the U.S. Qualified export receipts include, but are not limited to, gross receipts from:

- The sale, exchange, or other disposition of export property;
- The lease, license or rental of export property used outside the U.S. (including software);
- Services related to the qualified sale, exchange, lease, rental, or disposition of export property; and
- Engineering or architectural services for construction projects outside the U.S.

FDII Overview

The FDII rules allow C corporations a deduction of 37.5% of its FDII (reduced to 21.87% for tax years beginning after Dec. 31, 2025) resulting in a top federal effective tax rate (ETR) of 13.125% on eligible income (16.41% for tax years beginning after Dec. 31, 2025). The FDII deduction follows a formula approach to determine an annual deemed tangible return equal to 10% of the investment in depreciable fixed assets (QBAI). The excess of deduction eligible income (DEI) over this deemed tangible return is considered deemed intangible income (DII). The foreign derived portion of DEI or income earned from foreign use or activity is FDDEI. The formula is as follows:

- DEI = Gross income with certain modifications
- FDDEI = DEI derived from foreign use or activity
- DII = Excess of DEI over 10% return on QBAI
- FDII = (FDDEI / DEI) x DII

In addition, the sale of property for foreign use to non-U.S. persons located outside the U.S., including the lease, license, exchange, or other disposition of tangible or intangible property, qualifies as FDDEI. The income from the following categories of services provided or used outside the U.S. are FDDEI:

- Property Services – location of property

- Proximate Services – location of business or employees
- Transportation Services – origin and destination (50% foreign if U.S. is either one)
- General Services – recipient location

To qualify for FDII benefits, taxpayers must follow strict and complicated rules to document the foreign use or activity. Property sales to an unrelated U.S. person or to a foreign person for further manufacture in the U.S. do not qualify. In addition, services provided with respect to property or persons located in the U.S. do not qualify.

Transactions with foreign related parties have special rules. Property sales cannot qualify unless the product is resold to, or used in or incorporated in a product, which is resold to a foreign unrelated party and the taxpayer establishes to the satisfaction of the Secretary that it's for foreign use. Further, sales to a foreign related party of other than purchased property do not qualify, unless the seller reasonably expects more than 80% of revenue earned by the related party from use of the property from the unrelated party transaction qualifies for benefits.

General services provided to a foreign related party, who is a business recipient, qualify if not substantially similar to services provided by the related party to persons in the U.S. A substantially similar service is defined as one used by a foreign related party to provide services by the foreign related party to a person in the U.S., and either a benefits or price test is met. The benefit test is met if 60% or more of the benefits provided by the service were to persons located in the U.S. A benefit means to provide a reasonably identified increment of economic or commercial value to a customer and not an indirect or remote benefit. The price test is met if 60% or more of the price paid by a person located in the U.S. to the foreign related party was attributable to the U.S. services rendered to the foreign related party.

FDII or IC-DISC?

The FDII deduction results currently in an ETR of 13.125% on export income and then increases to 16.41% after 2025. If the related supplier is a C corporation, a commission IC-DISC using the 50% of net income method results in a 10.5% ETR on the export income after deducting the commission. A buy/sell IC-DISC results in no corporate level tax. When export related dividends are paid to individual shareholders from either, they pay the qualifying dividend rate.

FDII documentation requirements for foreign use or activity are more stringent to meet and may be harder to obtain from customers. As a result, more transactions may qualify for IC-DISC benefits than the FDII deduction. However, FDII applies to a broader range of services than the IC-DISC, which is limited to services related to the sale or lease of property and engineering and architectural services for projects located outside the U.S.

When a commission IC-DISC is used and transactions qualify for both FDII and IC-DISC benefits, a taxpayer may claim both on the same transaction. However, formula adjustments are needed in calculating the allowable deduction under both, as the IC-DISC commission reduces the FDDEI and the FDII deduction reduces the IC-DISC commission. Although the result is a reduced deduction under each calculation separately, the combined deduction may be greater.

The Takeaway

Clearly this is a complicated and highly fact-specific analysis and great care must be given in determining which provides a better tax benefit. However, if a closely held C corporation determines it is eligible for the FDII benefits, then the IC-DISC should be a consideration as well. Companies currently utilizing an IC-DISC should consider if they can benefit from the FDII deduction.

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