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Equity-Based Compensation in Today's Environment

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Introduction

It is late afternoon and you, the founder of a dynamic, successful start-up company, are staring out your office window at an unusually gray sky. Business is going well, you think to yourself. In the few years that the company has been in existence, it has undergone two or so rounds of venture capital financing, and you have been fortunate enough to see that your business keeps growing. You know that the time has come to hire an experienced and seasoned executive to help take your company to the next level and weather any storms ahead.

Yet you are faced with a common quandary for an early stage company: while such an executive is necessary to ensure a company's continued growth, such person comes with a price tag that is likely beyond the company's cash resources. Many companies, such as yours, have successfully managed this dilemma by paying their executives a lower salary and making up the differential with a handsome equity-based compensation package, an approach that is very much in the news these days as politicians, accountants, and others debate the relative merits and proper accounting treatment of stock options and other methods used to compensate executives. In this article, we will examine various forms of equity-based compensation used by early stage as well as mature companies and the relative advantages and disadvantages of each, particularly from a tax perspective. We will then suggest a creative and often overlooked form of equity-based compensation, designed to maximize the after-tax compensation to the executive and avoid certain potential pitfalls.[1]

Common Types of Equity-Based Compensation

Equity-based compensation for executives may take various forms. Although they all embody a common principle—holding a stake in the potential growth of the company—their structures, as well as their tax consequences, differ widely. Before we delve into the latter theme, a brief overview of the various forms of compensation commonly used is in order.

Stock Options Generally

Stock options typically confer upon the recipient the right to buy a specified number of shares of the company's stock at a specified price, called the “exercise” price or “strike” price, for a specified period of time. The exercise price is often set at the estimated fair market value of the stock[2] at the time the options are granted, and the option typically becomes exercisable over a period of time, referred to as the vesting period, tied to continued employment of the recipient or achievement of some other milestone. In theory, the option allows the recipient to profit from an increase in the value of the company's stock by exercising the option at the exercise price, to the extent it has become vested, and later selling the acquired stock at its then presumably increased value. Stock options are broadly divided into two categories: incentive stock options and nonqualified stock options.

Incentive Stock Options (ISOs)

This type of option receives certain favorable tax treatment but must conform with rigid requirements set forth in §422 of the Internal Revenue Code. The most basic of these requirements is that ISOs can only be issued to employees of a corporation. Employees of a partnership or limited liability company are not eligible. There must be, furthermore, a clearly delineated written plan fixing the number of shares set aside for issuance upon the exercise of options and the employees eligible to be the recipients of options, which plan must be approved by the corporation's shareholders within one year after its initial adoption by the corporation's board of directors. The exercise price of an ISO must at least equal the fair market value, at the date of grant of the option, of the shares subject to the option (or, in the case of ISOs granted to holders of 10 percent or more of the company's stock, must equal at least 110 percent of that fair market value). In order to preserve favorable tax treatment as an ISO, stock acquired through the exercise of an ISO must be held for at least two years from the date of grant of the option and for at least one year from the date the option is exercised. When structured in full compliance with these and other requirements for ISOs set forth in the Internal Revenue Code, ISOs are advantageous to the recipient from a tax perspective because the recipient avoids taxation until the sale, if any, of any shares purchased by the recipient under the ISO (except for any alternative minimum tax resulting from the exercise of the ISO),[3] and the gain recognized from that sale will often qualify for taxation at favorable long-term capital gain rates, as more fully discussed in “Review of Tax Consequences” below.

Nonqualified Stock Options (NSOs)

NSOs generally refer to all stock options that do not qualify as ISOs. Unlike ISOs, NSOs may be granted to persons other than employees, making them an attractive means of compensating consultants, advisers, strategic partners, and others.[4] In addition to being available for grants to non-employees as well as employees, NSOs differ from ISOs by permitting an exercise price lower than the fair market value of the underlying shares on the date of the option grant and by avoiding certain restrictions applicable to ISOs as to transferability and the maximum value of the underlying shares. Hence, while recipients of NSOs do not enjoy certain tax advantages of ISOs, NSOs often have greater applicability and flexibility.

Restricted Stock

Restricted stock grants are awards of company stock to a recipient that are subject to a vesting period and/or other restrictions, such as transfer restrictions. As with stock options, the recipient's ownership rights may vest over a certain period of time or upon the achievement of certain milestones or performance goals. Restricted stock has been increasingly viewed as an attractive alternative to options in light of the downturn in the stock market, as many stock options issued to employees several years ago are expiring at a time when the fair market value of the stock subject to the option is less than their exercise price (the option in that case often being referred to as "under water") and, consequently, are worthless to the recipient. In contrast, restricted stock preserves some value for the recipient even if the stock price declines below its value on the date of issuance of the restricted stock.

Phantom Stock and Stock Appreciation Rights (SARs)

For both phantom stock and SARs, the recipient receives a contractual right to a financial reward *as though he or she owned stock in the company*, but without actual ownership in the stock. The holder of phantom stock typically earns compensation based on the increase in value of a company's stock beyond the date of grant of the phantom stock and, depending upon the terms, may also be entitled to all or a portion of the value of that stock as of that grant date. SARs often differ from phantom stock in two important ways: the recipient is typically not entitled to the value of the underlying stock as of the date of grant of the SARs, and SARs are generally granted for a specified number of years. Because no actual stock is involved, these two forms of compensation may be of special interest where companies wish to tie compensation to the increase in value of the company stock, without necessarily surrendering an ownership interest in the company. While the compensation can be paid in the form of stock or other property, it is often paid in cash.

Review of Tax Consequences

In selecting a form of equity-based compensation, consideration of the tax consequences is essential. One significant factor to the recipient is the timing of recognition of taxable income: whether at the time of grant, vesting, or exercise of the security or at the time of the ultimate sale of or payment from the security. Tax deferral becomes especially important where the security being taxed cannot be sold for whatever reason to offset the taxes due.

Another significant factor to the recipient is the rate at which the security is taxed. Short-term capital gains are taxed at the same rates as ordinary income, which is currently capped at 38.6 percent for individuals for federal income tax purposes, while long-term capital gains are currently capped at 20 percent for individuals for federal income tax purposes. From the recipient's perspective, the goal is to recognize as much income as possible at the lower long-term capital gain rates and to defer the recognition of as much as possible of such income for as long as possible.

From the tax perspective of the company, it will typically be interested in receiving a tax deduction at some point with respect to the equity-based compensation, unless the existence of net operating losses has alleviated that concern. Accordingly, in choosing a form of equity-based compensation, the company must balance its interest in satisfying the recipient while at the same time trying to preserve a tax deduction, if desired, for itself.

Incentive Stock Options

Assuming that the ISO meets the requirements of §422 of the tax code, the recipient does not recognize taxable income when the ISO is granted or exercised (excluding any applicable alternative minimum tax resulting from the exercise of the ISO). Instead, the recipient would incur a taxable gain only as a result of the ultimate sale of any shares acquired pursuant to the ISO, which gain would equal the amount by which the sale proceeds exceeds the amount paid for the shares upon exercise of the ISO. For example, if the recipient exercised options to purchase 200 shares of stock at an exercise price of $1 per share and sold the shares when their fair market value was $5 per share, his or her taxable income from the sale would be the product of $4 multiplied by 200 shares, or $800. The good news for the recipient is that if the holding period requirement is met (at least two years from the date of the grant of the ISO and at least one year from the date of its exercise), then all of this gain will be taxed at long-term capital gain rates.

There is, however, one important tax limitation applicable to granting a significant number of ISOs to any one recipient, such as a key executive: to the extent that the aggregate fair market value of the shares subject to the ISO (valued at the option grant date) that can be purchased for the first time during any calendar year exceeds $100,000, the portion of the ISO covering such excess is treated as an NSO.[5]

Assuming that the ISO meets the requirements of §422, the company, on the other hand, will not receive a tax deduction on either the grant or exercise of the ISO (but would upon the exercise of an NSO), nor will it receive a tax deduction upon the sale of any shares purchased under the ISO that have been held for the requisite holding period described above.

Advantages	*Limitations*
• *No recognition of taxable income to the recipient upon grant of ISO.* • *No recognition of taxable income to the recipient upon exercise of ISO.* • *Appreciation on the underlying shares is taxed at long-term capital gain rates if the holding period is met, and recognition of taxable income is deferred until any sale of the shares.*	• *Stringent requirements under tax code greatly reduce use and flexibility of ISOs and present risk of defaulting to NSO tax treatment if requirements are not satisfied.* • *Only employees are eligible to receive ISOs and the company receives no tax deduction for the grant or exercise of ISOs.* • *$100,000 limit exists on the value of shares first becoming purchasable under the ISO during any calendar year.*

Nonqualified Stock Options

As in the case of an ISO, the recipient is not taxed on the grant of the NSO. However, upon exercise of the option, holders of NSOs face a potential tax problem: a gain is recognized in the amount by which the fair market value of the shares purchased on the date of the exercise exceeds their purchase price, which gain is taxed as ordinary income. If the NSO has restrictions upon the sale of those shares, if no public market exists yet for the shares, or if the shares have not been registered under applicable securities laws, the recipient may face a sizable tax bill without an ability to generate cash to pay the taxes by selling the shares.

If the recipient later sells the shares for a profit, the recipient will recognize either short-term or long-term capital gain, depending on whether he or she held the stock for more than a year prior to sale. Gain is recognized in the amount by which the sale price exceeds *the sum of* (i) the price for which the recipient bought the shares (i.e., the exercise price) *plus* (ii) the taxable income realized by the recipient upon the exercise of the NSO.

Unlike ISOs, companies are entitled to a deduction for income tax purposes equal to the income recognized by the recipient upon exercise of the NSO.[6]

Advantages	*Limitations*
• *Flexibility of use and terms.* • *No recognition of taxable income to the recipient upon grant of NSO.* • *The company is allowed a tax deduction in amount recognized by recipient as income upon exercise of NSO.*	• *Gain recognized upon exercise of the NSO is taxed at ordinary income rates.* • *Recognition of taxable income upon exercise of NSO may occur when shares purchased under the NSO are illiquid.*

Restricted Stock

An award of restricted stock generally becomes taxable to the recipient as it vests (i.e., as it becomes transferable or is no longer subject to a substantial risk of forfeiture). For example, if a restricted stock award vests one-quarter each year, then one-quarter of the total grant is taxable each year and the recipient recognizes compensation taxable at ordinary income rates with respect to the shares that have become vested in the amount by which the then current fair market value of those shares exceeds the amount (if any) that the recipient paid for those shares. Often, recipients do not pay any amount to receive restricted stock and, therefore, the full value of the stock upon its vesting would be subject to taxation at ordinary income rates. This presents the same problem as NSOs—the recipient has the prospect of paying a considerable tax bill while holding shares that are illiquid.

The Internal Revenue Code provides potential relief by allowing the recipient of restricted stock to make an election under §83(b) within 30 days after the grant. This election allows the recipient to immediately recognize, as ordinary income, the excess of the fair market value of the stock on the date of the grant (which is presumably much lower than at the time of vesting) over the purchase price, if any, paid for the stock. After that election, any gain recognized upon the sale of the stock over the recipient's tax basis in the stock (the value on the date of the grant) will then be taxed under the lower long-term capital gain rates, provided the shares are held for more than one year.[7] Of course, the recipient is still typically required to pay some amount of tax as a result of the §83(b) election at a time when the recipient has not yet received cash from the sale of the stock.[8]

The company is generally entitled to a tax deduction in the amount of the income recognized by the recipient at the time this income is recognized.[9]

Advantages	*Limitations*
• *No tax upon grant of restricted stock subject to vesting, unless election is made under §83(b).* • *Upon §83(b) election, and presuming more than one-year holding period is met, all appreciation in value of shares after grant will be taxed as long-term capital gain.* • *The company receives a tax deduction when recipient recognizes taxable income.*	• *Absent §83(b) election, tax is due when stock vests.* • *Upon §83(b) election, recipient is taxed on the fair market value of stock on the date of grant (less any purchase price paid) at ordinary income rates.* • *Upon §83(b) election, recipient must pay tax when shares are illiquid.*

Phantom Stock and Stock Appreciation Rights

Under both of these forms of compensation, the recipient is ordinarily taxed only when he or she exercises the right to receive payment. The full amount of the payment (including the fair market value of any non-cash property, such as stock, received) is taxed to the recipient as ordinary income in the year of receipt, and the company receives a corresponding tax deduction at such time.

Advantages	*Limitations*
• *Ordinarily, no taxable income to the recipient upon grant.* • *The company receives a tax deduction when recipient recognizes taxable income.* • *Particularly attractive where the company desires to tie compensation to value of stock without issuing actual ownership interests in the company.*	• *The payment is taxed as ordinary income in the year it is received.* • *Generally, no portion of the taxable income related to the award is taxed at long-term capital gain rate (except for any long-term gain realized from the subsequent sale of shares, if any, received from the company as payment under the award)*

Accounting Debate

Many find it intuitive that equity-based compensation has a value to the recipient and, therefore, likely represents a cost to the company. The appropriate treatment of that compensation for accounting purposes is less straightforward and is currently the subject of much debate in Congress and corporate boardrooms across America, particularly in the context of stock options. In accordance with current accounting rules, the value attributed to the grant of stock options is often required to be disclosed only in the notes to the financial statements, rather than pursuant to the alternative approach of reflecting an actual expense for such value in the company's financial statements.[10] In July 2002, the Coca-Cola Company and the Washington Post made headlines by announcing their decision to treat the grant of all stock options as giving rise to expenses for purposes of their financial statements (i.e., as creating a charge to reported earnings), and these companies have since been followed by numerous others. The argument often presented in favor of recording compensation expense for the grant of stock options is that, while such expense may hurt the market valuation of companies by reducing earnings, this treatment will make financial statements more meaningful and may ultimately curtail potential abuse of this form of compensation in many corporations. Although initial efforts to mandate that companies expense stock options have stalled in Congress, legislators and regulators will no doubt continue to grapple with this issue. Currently, the Financial Accounting Standards Board in the United States has undertaken a project to study the imposition of such a requirement, and one can also expect the Public Company Accounting Oversight Board established pursuant to §101 of the Sarbanes-Oxley Act of 2002 to consider the issue as well.

Restricted Stock With A Twist

As discussed above, each of the common forms of equity-based compensation has both advantages and disadvantages, especially from a tax perspective. The disadvantages are compounded for a non-public company mature enough to have a stock value greater than a merely nominal amount, since the securities may generate a good deal of income tax that is payable at unfavorable rates and/or due at a time when the securities are illiquid. To combat this problem, we would suggest consideration of a creative and all too often overlooked form of compensation: restricted stock with a "non-lapsing" restriction, such as a repurchase right in favor of the company. This twist on restricted stock can minimize the amount of taxable income recognized as ordinary income, defer most of the taxable income until a sale of the security occurs and preserve the potential for a significant long-term capital gain.[11]

Under this form of compensation, the recipient receives restricted stock that, in addition to having typical vesting provisions, is subject to a restriction that does not lapse (i.e., it continues beyond the stock's other vesting requirements). For example, the company could retain the right to repurchase the stock (often referred to as a right of first refusal), upon any proposed sale by the executive, for a price equal to the amount by which the stock's fair market value *at the time of the proposed sale* exceeds a fixed amount established at the time of the restricted stock grant (which fixed amount, to minimize taxes upon the grant of the stock, could be set at almost the entire fair market value *at the time of grant*). In other words, if shares without the "non-lapsing" right of first refusal would be worth $10 per share at the date of grant and the shares actually awarded to the executive are subject to a "non-lapsing" right of refusal entitling the company to repurchase the shares at their fair market value per share (as the same fluctuates from time to time) less $9.90, the fair market value of the shares awarded would be 10 cents per share for purposes of calculating any taxable income in connection with their grant under §83(a) of the Internal Revenue Code.

As with standard restricted stock awards that are subject to a vesting restriction that lapses over a period of time, an executive receiving restricted stock subject to a "non-lapsing" restriction and a vesting period could make a §83(b) election within 30 days after grant of the stock and recognize ordinary income equal to the amount by which the fair market value of the stock on the date of grant (10 cents per share in our example) exceeds the amount, if any, actually paid by the executive for such award. Because of the "non-lapsing" restriction, the executive is permitted to take a steep discount (a $9.90 discount in our example) from the fair market value of comparable restricted stock without the "non-lapsing" restriction in determining his or her taxable income at the time of such election. In so doing, the executive would recognize ordinary income instead only on the nominal amount that would be due to the executive upon a hypothetical repurchase at the time of the grant of the stock (less any amount actually paid by the executive for the restricted stock upon its grant). The executive consequently enjoys a significantly reduced tax burden at the time of the §83(b) election versus a standard restricted stock award.[12] Following the election, as with standard restricted stock awards, any subsequent appreciation recognized at the time of the sale of the stock would be taxed at the lower long-term capital gain rates, assuming the one-year holding period has been met.

Because of the steep discount made possible by the "non-lapsing" restriction, an executive can make a §83(b) election with respect to many more shares than in the case of typical restricted stock, without feeling the tax "bite" upon the election (although the executive has potentially lost the existing value of the stock as of the date of grant through any subsequent exercise by the company of its right of first refusal). In addition, the executive can also obtain more shares sooner and cheaper through this method than through a typical stock option arrangement because of the absence of the substantial exercise price usually payable upon exercise of a stock option and the absence of any vesting period required to exercise the option. In the event the "non-lapsing" restriction is ever cancelled by the company, the executive would also gain the value of the shares lost as a result of the "non-lapsing" repurchase right.

It should be noted that most cancellations of the "non-lapsing" restriction, especially a pre-existing agreement at the time of grant to cancel the restriction upon certain events, would defeat the "non-lapsing" nature of the restriction for tax purposes, thereby undermining the valuation discount and resulting in additional taxable income to the executive upon the cancellation or agreement to cancel. However, there is at least one event upon which the IRS has expressly permitted the cancellation of a "non-lapsing" restriction without affecting the valuation discount or requiring the recognition of taxable income (which in effect allows the executive to have his cake and eat it too): a cancellation in connection with an initial public offering of the company's securities.[13] In that case, the executive would still be permitted to make a §83(b) election within 30 days after the restricted stock grant and use a steep valuation discount in determining the tax then payable. Thereafter, *all* appreciation in the stock over that low valuation at the grant date would be treated as long-term capital gain, assuming that the one-year holding period has been met, even though a significant amount of the appreciation could be attributable to cancellation of the "non-lapsing" restriction.

The example in the table below illustrates the tax benefits associated with this form of restricted stock award by showing the results of (i) making or not making a §83(b) election and (ii) the company having (and exercising) or not having a "non-lapsing" right of first refusal to repurchase the shares, in this case for a purchase price equal to the amount by which the then current fair market value per share of the shares exceeds $9.90.

The table below assumes the grant (for no consideration) of 10,000 shares of restricted stock with a fair market value at the time of the grant of $10 per share. The shares

- *vest three years after grant;*
- *appreciate by 50 percent (to $15 per share) three years after grant; and*
- *are sold five years after grant when their fair market value is $20 per share.*

The table also assumes, for illustrative purposes, a combined (federal and state) ordinary income rate of 45 percent and a combined long-term capital gain rate of 26 percent. The "after tax value" indicated below represents the value of the award net of all taxes paid on the award at or before the time in question. No adjustment has been made for the time value of money.

Restricted Stock Award		**At Grant: ($10 Share)**	**At Vesting: ($15 Share)**	**At Sale: ($20 Share)**	**Total Tax Payable**
No Right of First Refusal and No §83(b) Election Made	*Value of Award*	$100,000	$150,000	$200,000	
	Tax Payable	-0-	67,500	13,000	**$80,500**
	After Tax Value	100,000	82,500	119,500	
No Right of First Refusal but §83(b) Election Made	*Value of Award*	$100,000	$150,000	$200,000	
	Tax Payable	45,000	-0-	26,000	**$71,000**
	After Tax Value	55,000	105,000	129,000	
Right of First Refusal but No §83(b) Election Made	*Value of Award*	$1,000	$ 51,000	$101,000	
	Tax Payable	-0-	22,950	13,000	**$35,950**
	After Tax Value	1,000	28,050	65,050	
Right of First Refusal and §83(b) Election Made	*Value of Award*	$1,000	$ 51,000	$101,000	
	Tax Payable	450	-0-	26,000	**$26,450**
	After Tax Value	550	50,550	74,550	

As shown above, the executive receiving a restricted stock award subject to the non-lapsing restriction and making a §83(b) election is able to receive a substantial number of restricted shares with a minimal tax "bite" until actual sale of the shares. In the event the non-lapsing restriction is cancelled in connection with an initial public offering[14] and a §83(b) election had been made at the time of grant, the after-tax value of the award to the recipient at the time of sale is higher than in any of the circumstances shown above (a whopping ***$147,810*** instead of the $74,550 otherwise shown above, with a total tax payable in that case of only $52,190,[15] almost all of which is calculated at long-term capital gain rates and deferred until the sale of the stock). Accordingly, this form of restricted stock award should be of particular interest to executives of privately held companies that hope some day to conduct an initial public offering, when market and company conditions permit.

Conclusion

Equity-based compensation can provide a company with the means to attract seasoned executives who may be otherwise unaffordable. However, the tax consequences of the various compensation forms are complex and differ widely, especially in terms of the timing of the taxation and the tax rate involved. Despite all the recent negative publicity, it seems clear that equity-based compensation is here to stay as a viable and appropriate means of compensation in many cases, although it promises to remain in the spotlight as politicians, executives, and others continue to debate its relative vices and virtues and proper accounting and tax treatment.

As we have indicated, each of the commonly used forms of compensation has benefits and limitations. On balance, an often overlooked form of equity-based compensation, restricted stock with a "non-lapsing" restriction, appears well-suited to minimize taxable income up front to the recipient, likely deferring almost all of it until the lower long-term capital gain rate would apply and cash is available to the recipient from a sale of the security. This method not only softens the tax burden to an executive receiving the security, but also avoids any cash outlay for the purchase price of the security, while at the same time preserving the potential for significant equity appreciation. The result is a more attractive compensation package that can be offered to land the executive you need to take your company to the next level.

Footnotes

[1] The authors acknowledge the assistance of Sasha N. Badian, an Associate at the Firm, in the preparation of this article.

[2] Valuation of stock that is publicly traded is often easily accomplished by reference to the reported price of the stock, but is more complicated in the case of stock that is not publicly traded. In the latter case, valuation typically involves reference to a current appraisal of the company, recent sales of stock by the company or a formula driven approach applied to an available financial measure (e.g., valuing the company based upon a particular multiple of its prior year earnings).

[3] While the exercise of an ISO does not result in taxable income pursuant to I.R.C. §422(a)(1), the amount by which the then current fair market value of the shares purchased upon exercise of the ISO exceeds their purchase price under the ISO is included as income under I.R.C. §56(b)(3) for purposes of computing any alternative minimum tax payable with respect to the tax year in which the ISO is exercised, unless there is a disqualifying disposition (i.e., a sale of the shares acquired upon exercise of the ISO prior to the expiration of the applicable holding period) in the year in which the option is exercised.

[4] In some cases, a company will issue warrants in lieu of NSOs, which are treated like NSOs for tax and accounting purposes and likewise confer upon the recipient the right to buy a set number of securities at a predetermined exercise price, but often lack a vesting requirement.

[5] I.R.C. §422(d).

[6] I.R.C. §83(h).

[7] There is nonetheless the risk that the shares will be forfeited by the recipient because a condition to their vesting has not been met, in which case the recipient is not permitted to take any tax deduction for any portion of the income previously recognized as a result of the §83(b) election. I.R.C. §83(b)(1)

[8] When companies grant loans to their employees to pay costs relating to restricted stock, complications can arise. For example, if the loan to the employee is non-recourse (i.e., only the stock is at risk), the holding period for calculating any long-term capital gain on the shares often does not begin until the loan is fully repaid. *See* Treas. Reg. §1.83-3(a)(2). It should be noted, however, that under §402 of the Sarbanes-Oxley Act of 2002, loans to executive officers or directors of public companies are prohibited in almost all cases. (Pub. L. No. 107-204, adding subsection (k) to §13 of the Securities Exchange Act of 1934.)

[9] In the case of a public company, a $1 million limit on the deduction may apply in certain circumstances for compensation given to the chief executive officer and its next four highest compensated executives. I.R.C. §162(m).

[10] The treatment for financial accounting purposes of equity-based compensation varies depending upon the type and terms of the compensation and, where a choice is permitted, the method of accounting selected. For example, the company incurs compensation charges as phantom stock, restricted stock and SARs vest but, under current accounting rules, the company is often not required to expense stock options and may instead choose to show the pro-forma effect on earnings of the option grants in the notes to its financial statements. The accounting rules specify certain valuation techniques to be used for purposes of estimating the related compensation expense. *See* Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123 (Financial Accounting Standards Bd. 1995).

[11] We note that the IRS has permitted an S corporation to issue restricted stock subject to a non-lapsing restriction only on a case by case basis, after examination of whether or not an impermissible second class of stock has been created. *See*, *e.g.*, Priv. Ltr. Rul. 93-08-022 (Nov. 25, 1992). Accordingly, an S corporation may wish to obtain a private letter ruling from the IRS before using this form of compensation to avoid the possibility of jeopardizing its tax status.

[12] However, it must be noted that the executive has potentially lost almost all of the current value of the stock, since the company's repurchase price excludes almost all of the existing value of the stock as of the date of grant.

[13] *See* Treas. Reg. §1.83-5(b). The cancellation of the restriction must not be deemed compensatory to the executive to avoid triggering the recognition of taxable income; cancellation of a “buy-sell” restriction in connection with an initial public offering is cited by the IRS as an example of a situation where removal of the restriction generally is regarded as non-compensatory. In addition, the executive should receive from the company a written statement to file with his or her tax return indicating that the company will not take a tax deduction in connection with the cancellation.

[14] *See supra* note 13.

[15] In that case, $1,000 of value of the restricted stock would be taxed upon the §83(b) election as ordinary income, at a 45 percent combined federal and state tax rate in our example, and the remaining $199,000 of appreciation would be taxed as a long-term capital gain, at a 26 percent combined federal and state tax rate in our example.