

A stock bonus is just paper – it can't be taxable!

Joe is feeling very grateful to his general manager, Fred, for all of his hard work, so Joe gives Fred some stock in the company. When it comes time to file their tax returns, they are horrified to hear that Fred is going to have to pay taxes on the value of that stock.

How could this be? It is just a piece of paper. That can't be taxable. It is a gift!

First, it is not just a piece of paper. Stock ownership brings with it the right to dividends, the right to vote, the right to review company books and records, and the right to have the management be responsible if there is improper management of the company.

Second, it is not a gift for tax purposes. The tax law does not recognize that an employer gives an employee anything. The employee earns compensation and is taxed on it.

When the employer company issues stock to the employee, it is treated as if there were two steps:

- the employer paid the employee cash (and the employee is of course taxed at ordinary income rates on that cash payment, and the employer claims a tax deduction) and
- the employee paid the cash back to buy the stock

Isn't there any way around this? There are some options, but the general rule above is correct. The employee is taxed on compensation, and it doesn't matter whether that compensation comes in the form of a paycheck or whether it is stock.

Joe Pays the Taxes – Joe could give Fred the money to pay the taxes. That is an additional bonus to Fred and thus Fred pays even more in taxes (or Joe does). Problem --- that is additional money out of pocket for Joe, and although he is grateful for Fred's work, this is getting ridiculous.

Vesting – Joe could require that Fred vest into the stock, perhaps vesting over 4 years at the rate of 25% per year. In that case, Fred could pay the taxes on 25% of the value of the stock each year for 4 years. Problem ---- Fred still pays taxes on the stock value at ordinary income rates, and if the stock has gone up in value at the time of vesting, he pays taxes on that increase in value too.

Compensation Package – Joe could give Fred a cash compensation package that approximates what he would have if he owned the stock. Fred could get a bonus

instead of the stock dividend. Fred could get a severance package when he leaves that would equal the value of the stock. Problem ---- this is all ordinary income to Fred as he receives it. He does not get the benefit of capital gain rates. However, this is often the option that both the employer and the employee pick.

Note that if the company is an LLC instead of a corporation there is more flexibility. Joe could give Fred part ownership in the increase in value of the company but not ownership of the current value of the company. This is called a "profits interest". However, if the company is already a corporation then changing to an LLC can cause tax problems for Joe. The IRS treats this as if Joe sold the company (including its goodwill) for cash, and thus Joe has to pay taxes on all of that gain even though all he did was to change the form of the company.

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