Deloitte.

Financial Reporting Alert 18-7
June 6, 2018

Contents

Emerging Growth Companies — Common-Stock Repurchase Transactions

by Aaron Michael Shaw and Bernard De Jager, Deloitte & Touche LLP

Introduction

Various stock transactions with employees of a nonpublic emerging growth company (the "nonpublic entity") involve significant judgment and complexities that may have a material impact on the nonpublic entity's financial statements. In addition, such transactions often have certain tax implications for both the nonpublic entity and its employees. These stock transactions can be between the nonpublic entity and its employees, a preexisting investor and the nonpublic entity's employees, or a new investor and the nonpublic entity's employees.

This second installment in our special *Financial Reporting Alert* series for start-up companies discusses accounting, valuation, tax, and interpolation framework considerations for nonpublic entities related to various transactions involving the repurchase of a nonpublic entity's common stock.

Accounting Considerations

Transactions Directly Between a Nonpublic Entity and Its Employees

When a nonpublic entity repurchases common shares from its employees at an amount greater than the estimated fair value of the shares at the time of the transaction, the excess of the purchase price over the fair value of the common shares generally represents employee compensation. The excess amount attributable to compensation would be reflected in the nonpublic entity's financial statements as compensation cost.

ASC 718[1] discusses the accounting for repurchases at a price in excess of fair value. Specifically, ASC 718-20-35-7 states the following:

> The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. **Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost.** An entity that repurchases an award for which the requisite service has not been rendered has, in effect, modified the requisite service period to the period for which service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date. [Emphasis added]

For example, a nonpublic entity may repurchase shares from its existing employees in connection with a convertible preferred stock financing. As part of the financing, the entity may set aside a specified amount of the money to repurchase common stock from its existing employees and thereby provide liquidity to its employees. It is not unusual for an entity to repurchase common shares by using the price established for the preferred stock in the most recent round of financing. Accordingly, a nonpublic entity would need to evaluate whether the price of the preferred stock is equal to the value of the common stock. Typically, the value of preferred shares will exceed the value of common shares (assuming one-to-one conversion) because of preferential rights normally associated with preferred shares. As a result, the excess amount (i.e., the difference between the purchase price and the fair value of the underlying shares) would be reflected in the nonpublic entity's financial statements as compensation cost in accordance with ASC 718-20-35-7.

Transactions Directly Between a Preexisting Investor and the Nonpublic Entity's Employees as Part of a Financing Transaction

On occasion, investors (e.g., private equity or venture capital investors) intending to increase their stake in an emerging nonpublic entity may undertake transactions with other shareholders in connection with a recent financing round. These transactions may include investors' purchase of common shares directly from the founders of the nonpublic entity or other individuals who are also considered employees of the nonpublic entity. Because the transactions are between employees of the nonpublic entity and existing shareholders and are related to the transfer of outstanding shares, the nonpublic entity may not be directly involved in them (although it may become indirectly involved by facilitating the exchange or not exercising a right of first refusal).

Sometimes, if there is sufficient evidence that a transaction is an arm's-length fair value transaction, it may be necessary to treat the transaction as a data point in the estimation of the fair-value-based measurement of share-based payment awards. Other times, particularly when a transaction involves founders or a few select key employees, it may be difficult to demonstrate that the transaction is not compensatory. If the price paid for the shares exceeds their fair value at the time of the transaction, it is likely that the nonpublic entity will be required to recognize compensation cost for the excess regardless of whether the entity is directly involved in the transaction. It is important for a nonpublic entity to recognize that

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

transactions such as these may be subject to the guidance in ASC 718 because the investors are considered to be holders of an economic interest in the entity.

ASC 718-10-15-4 states the following:

> **Share-based payments awarded to an employee of the reporting entity by a related party or other holder of an economic interest[2] in the entity as compensation for services provided to the entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for services to the reporting entity.** The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to its employee in exchange for services rendered. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the employee that is unrelated to employment by the entity. [Emphasis added]

Although the presumption in such transactions is that any consideration in excess of the fair value of the shares is compensation paid to employees, nonpublic entities should consider whether the amount paid is related to an existing relationship or to an obligation that is unrelated to the employees' services to the entity in assessing whether the payment is "clearly for a purpose other than compensation for services to the reporting entity." Even though it is difficult to demonstrate that a non-fair-value transaction with employees is clearly for other purposes, AIN-APB 25[3] (superseded by FASB Statement 123(R)[4]) describes situations when doing so may be possible, including those in which:

- "[T]he relationship between the stockholder and the corporation's employee is one which would normally result in generosity (i.e., an immediate family relationship)."
- "[T]he stockholder has an obligation to the employee which is completely unrelated to the latter's employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation)."

Accordingly, a nonpublic entity should consider all facts and circumstances.

Transactions Directly Between a New Investor and the Nonpublic Entity's Employees as Part of a Financing Transaction

As part of a financing transaction between a nonpublic entity and a new investor who is acquiring a significant ownership interest in the nonpublic entity, the new investor may repurchase common shares in the nonpublic entity from employees of the nonpublic entity. In this particular fact pattern, the investor did not participate in a prior financing arrangement and is purchasing convertible preferred stock from the nonpublic entity and common stock from the nonpublic entity's existing employees. The price paid by the investor to purchase the preferred stock from the nonpublic entity and the common stock from the employees is the same. Although the new investor did not hold an economic interest before entering into the transaction with the nonpublic entity, the new investor is not dissimilar to a party who already holds an economic interest in the nonpublic entity and may have similar motivations to compensate employees.

[2] ASC 718-10-20 defines an economic interest in an entity as "[a]ny type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses."

[3] AICPA Accounting Interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees: Accounting Interpretations of APB Opinion No. 25*.

[4] FASB Statement No. 123(R), *Share-Based Payment*.

As noted in ASC 718-10-15-4, a principle of ASC 718 is that a share-based payment arrangement between the holder of an economic interest in a nonpublic entity and an employee of the nonpublic entity should be accounted for under ASC 718 unless the arrangement is clearly for a purpose other than compensation for services. If a new investor purchases common stock valued at an amount based on the value of the preferred stock, we would generally expect the analysis to be similar to that applied when a preexisting investor purchases common stock from a nonpublic entity's employees.

Valuation Considerations

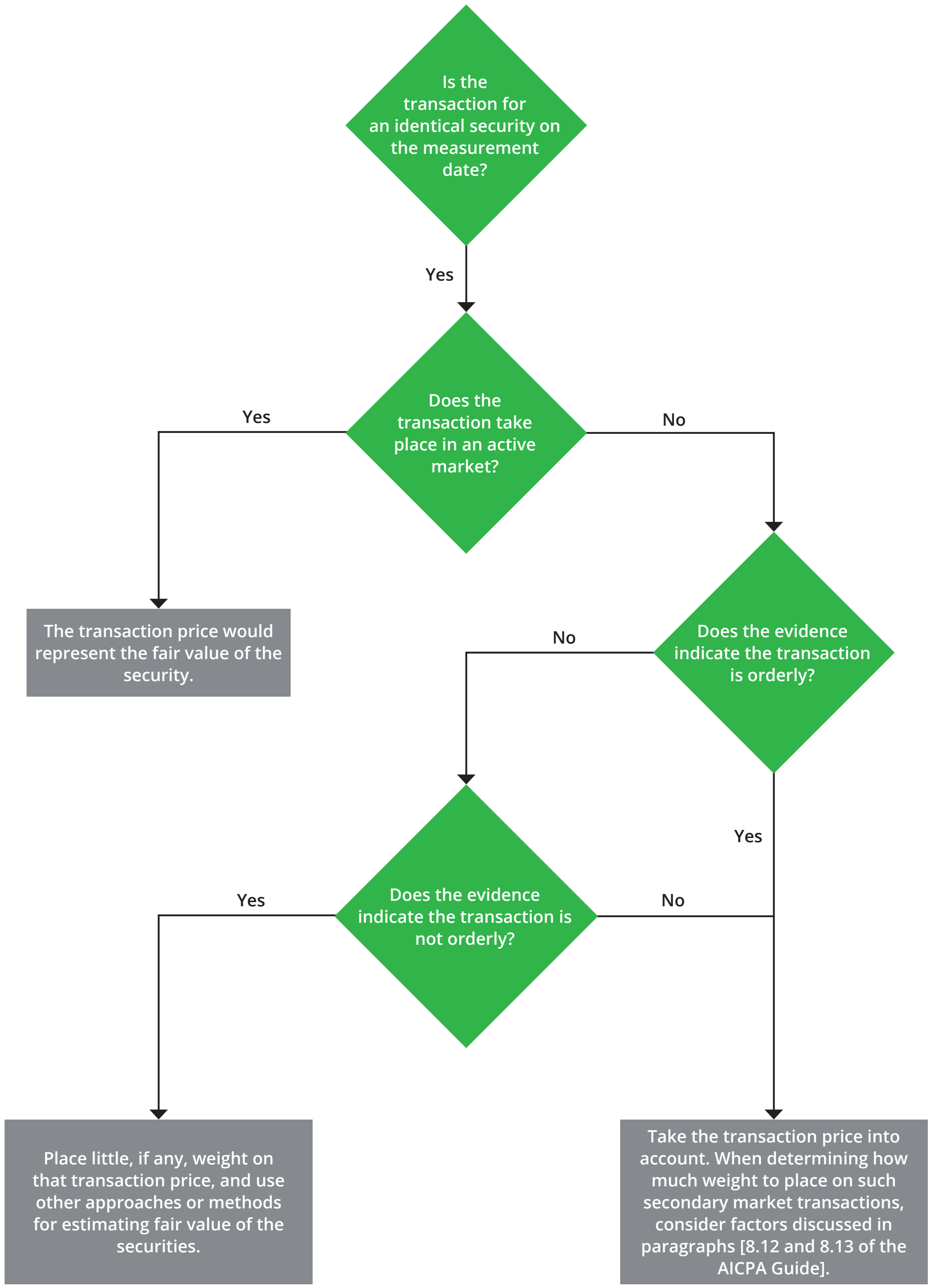
While the examples above describe situations in which it is likely that the nonpublic entity would recognize additional compensation cost, we are aware of fact patterns in which a secondary market transaction between an investor and a nonpublic entity's employees represents an orderly arm's-length transaction conducted at fair value. In these fact patterns, the nonpublic entity can adequately support a conclusion that the transaction was conducted at fair value and therefore did not result in additional compensation cost. Often, the stock repurchase is a secondary market transaction, the nonpublic entity does not enter into a separate financing transaction concurrently, and the investor has not acquired a significant ownership interest in the nonpublic entity. If the nonpublic entity can support a conclusion that the stock repurchase transaction was conducted at fair value and was not compensatory, we would expect the entity to incorporate the transaction into its common-stock valuation, which a third-party valuation firm typically performs to ensure compliance with Section 409A of the Internal Revenue Code (IRC) and determine the fair-value-based measure of the nonpublic entity's share-based payment arrangements.[5] For this type of transaction, we would expect the nonpublic entity to consider both compensatory and noncompensatory indicators when evaluating the substance of the transaction.

Upon determining that a secondary market transaction is noncompensatory, a nonpublic entity should consider the following guidance in paragraph 8.07 of the AICPA's Accounting & Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the "AICPA Guide") when assessing whether it should factor the secondary market transaction into its Section 409A valuation for determining the fair value of its common stock:

> When evaluating secondary market transactions and their relevance for estimating fair value of the equity securities within an enterprise, the [AICPA's Equity Securities Task Force (the "task force")] recommends considering the following framework, which is consistent with guidance in FASB ASC 820:
>
> If there is a transaction for an identical security on the measurement date and
>
> - if the transaction takes place in an active market, then the task force believes the transaction price would represent the fair value of the security.[FN3]
> - if the evidence indicates that the transaction is orderly, then the task force believes that transaction price should be taken into account. The amount of weight placed on that transaction price when compared with other indications of fair value will depend on the facts and circumstances, including the volume of the transaction.
> - if the evidence indicates that the transaction is not orderly, then the task force believes little, if any, weight should be placed on that transaction price.
> - if the company does not have sufficient information to conclude whether a transaction is orderly, then the task force believes it should take into account the transaction price (that is, give it some weight in the analysis.)
>
> FN3 Note that in [ASC 718] and [ASC] 505-50, restrictions that apply only during the vesting period are not considered in assessing the fair value of the security; however, post-vesting restrictions may be considered.

5 Independent valuations of common stock are often referred to as "Section 409A valuations" since they are subject to the requirements of that IRC section.

The following flowchart shows these steps.



Tax Considerations

For tax purposes, stock repurchases are generally treated either as capital (e.g., capital gain) or as dividend-equivalent redemptions (e.g., ordinary dividend income to the extent of earnings and profits). Repurchases from current or former service providers (i.e., current or former employees or independent contractors) give rise to an additional question about whether any of the proceeds should be treated as compensation for tax purposes.

In the assessment of whether a portion of the payment is compensation, a critical tax issue is what value is appropriate for the nonpublic entity to use when determining the effect of the capital redemption. That is, the nonpublic entity must determine whether some portion of the consideration for the repurchase represents something other than fair value for the common stock (i.e., compensation cost). When a repurchase exceeds the fair value of the common stock, there is risk that some of the purchase consideration is compensation for tax purposes. The determination of whether such excess is compensatory depends on the facts and circumstances, and **there can be disparate treatment for book and tax purposes with respect to compensation transactions** along with ambiguity in the existing tax code. Relevant factors include whether the repurchase is (1) performed by the nonpublic entity or an existing investor or (2) part of arm's-length negotiations with a new investor, who may not have the same information as the nonpublic entity about what is considered to be the fair market value of the stock. If the purchaser is not the nonpublic entity, it is relevant whether the shares will be held by the buyer, or whether they can be converted into a different class of stock or put back to the nonpublic entity. Another factor is whether an offer to sell at a higher price is limited to service providers or is available to shareholders more generally.

If the repurchase resulted in compensation for tax purposes, the nonpublic entity would include the additional compensation on Form W-2 (for employees) or Form 1099-MISC (for independent contractors). While any tax liability resulting from additional compensation is the obligation of the individual, the nonpublic entity has an obligation to (1) withhold income and payroll taxes from payments to employees and (2) remit the employer share of payroll tax. If the nonpublic entity does not withhold payroll taxes from an employee in a transaction when the excess purchase price is compensatory, the nonpublic entity becomes responsible for the tax and should evaluate whether it should accrue a liability in accordance with ASC 450, which addresses the proper accounting treatment of non-income-tax contingencies such as sales and use taxes, property taxes, and payroll taxes.

An estimated loss contingency, such as a payroll tax liability, is accrued (i.e., expensed) if (1) it is probable that the liability has been incurred as of the date of the financial statements and (2) the amount of the liability is reasonably estimable. A loss contingency must be disclosed if (1) the loss is probable as of the date of the financial statements or it is reasonably possible that the liability has been incurred and (2) the amount is material to the financial statements.

With respect to a payroll tax liability, the liability recorded as a tax transaction should be the best estimate of the probable amount due to the tax authority under the applicable law, which would include interest and penalties. In addition, the nonpublic entity would need to evaluate whether it has any arrangements in place with its employees that would make it responsible for its employees' tax liability. If the best estimate of the liability is a range, and if one amount in the range represents a better estimate than any other amount in the range, that amount should be recorded in accordance with ASC 450-20-30-1. If no amount in the range is a better estimate than any other amount, an entity should use the minimum amount in the range for recording the liability in accordance with ASC 450-20-30-1.

An entity has a legal right to seek reimbursement for the payroll tax liability (although not for income tax withholding, penalties, or interest) from employees if the IRS makes a determination to seek the withholdings from the entity. Accordingly, an entity could record an offsetting receivable from the employees for the payroll tax withholdings. However, an entity will need to assess the collectibility of such a receivable, including whether the entity has sufficient evidence of an employee's ability to reimburse the entity for the payroll tax liability and whether the entity has the intent to collect this liability from the employee.

The following is an example of a disclosure that an entity may make about its repurchase of common stock from its employees when it has incurred a payroll tax liability as a result of not withholding payroll taxes:

> In connection with our Series A financing, we repurchased common shares from our employees. The transaction was undertaken to provide liquidity to our employees and allows us to offer investors additional Series A shares without further dilution of the existing shareholders. While we have viewed the transaction to be a capital transaction for tax purposes, tax authorities could challenge this characterization and consider a portion of the payment to be compensation to the employees, which would require us to remit payroll tax withholdings to the tax authorities. For the probable amount of taxes and penalties that may be payable, the Company has recorded a liability of $5.0 million, which represents the low end of the range of probable amounts of payroll tax withholdings and penalties that would be payable. The ultimate payment amount could exceed the liability recorded, and we estimate that the reasonably possible range of such payment could be up to $8.0 million.

Given the complexities of this type of transaction, including the evaluation of existing tax law, entities should consult with their auditors and tax specialists when quantifying the liability under ASC 450.

Note that if a payment is considered to be compensation, there would also be a deduction allowed in the same amount (subject to all applicable rules related to deductions for compensation expense).

Interpolation Framework Considerations

In the first installment in our special *Financial Reporting Alert* series for start-up companies, we provided a framework that a nonpublic entity can use to interpolate the value of its common stock for financial reporting purposes. The interpolation framework does not affect an entity's evaluation of the tax considerations discussed above. That is, for tax purposes, an entity is permitted to use the most recent Section 409A valuation under the 12-month safe harbor method[6] without triggering tax compensation, provided that the stock valuation continues to be reasonable under IRC Section 409A. For financial reporting purposes, the entity may determine the fair-value-based measure of its equity awards by using the interpolation framework. However, the entity would not have a payroll tax withholding obligation if the interpolated value of the entity's common stock exceeded the most recent Section 409A valuation used to determine the repurchase price.

[6] According to IRC Section 409A regulations, a stock valuation is not "reasonable" if it is more than 12 months old.