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STARTUP ESSENTIALS: Structuring Equity Compensation Wisely

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Topics

- Basic characteristics and tax consequences of equity grants:
  - Stock options
  - Restricted stock
  - Restricted stock units (RSUs)
- Other issues a startup company should consider when granting equity
  - Scope of equity compensation program
  - Section 409A and valuation issues

Basic Characteristics and Tax Consequences of Equity Grants

Stock Options

- Stock options give the holder (the optionee) the right to purchase a number of shares of stock at a fixed exercise price
- Optionee bears no investment risk until exercise
- Most common form of equity compensation granted to employees
- Two types of stock options:
  - Incentive stock options (ISOs)
  - Non-qualified stock options (also called non-statutory stock options, or NSOs)

Stock Options, cont.

- Exercise price must be at least equal to the fair market value (FMV) on the date of grant to be exempt from Section 409A
- Typically vest in installments over 4 or 5 years with continued service
- Typical term is 10 years after the date of grant
  - Options usually expire after some period of time following separation from service (often 90 days), if earlier

Types of Options

- ISO – meets the requirements of Section 422 of the Internal Revenue Code (Code), including:
  - Exercise price at least FMV on grant date
  - 10 year term from grant date
  - Optionee must be an employee on the grant date
  - Must be exercised while optionee is an employee or within three months after termination (or one year in the event of disability)
  - No more than $100,000 exercisable in any calendar year
- NSO
  - Does not meet the requirements of Section 422 of the Code
  - Includes options granted outside of an equity incentive plan or to foreign recipients

Non-Statutory Option: Tax Consequences

- No tax at grant or on vesting
- Optionee is taxed on exercise on the excess of FMV of the stock on the exercise date over the exercise price (spread value)
  - Taxed at ordinary income rates
  - Exercise of NSO is subject to Code Section 83
- Employer must collect withholding taxes based on the spread value
- Optionee's capital gains holding period begins on date of exercise

Non-Statutory Options: Early Exercise

- Startup can grant options to purchase stock that is not vested (“early exercise” options)
- Code Section 83(b) election triggers taxation and starts capital gains holding period
- 83(b) election must be filed within **30 days** of exercise. If optionee files timely election:
  - Optionee includes the spread value as ordinary income in the year of exercise
  - No additional income is recognized when the stock vests
  - Capital gains holding period begins on exercise date for any gain above the spread value at exercise

Incentive Stock Options: Tax Consequences

- No tax at grant or vesting
- No regular federal income tax on exercise
- Long term capital gain (LTCG) on sale if stock purchased is held for more than one year after exercise date **and** for more than two years after grant date
  - Earlier sale or other disposition (disqualifying disposition) generally results in ordinary income tax on the spread value on exercise
- No employment taxes due on exercise of an ISO

Incentive Stock Options: Tax Consequences, cont.

- Alternative Minimum Tax (AMT) may be triggered on exercise
  - The spread value on exercise is subject to AMT
- AMT paid in connection with ISOs is generally creditable against future years' income tax in excess of such years' AMT

Incentive Stock Options: Tax Consequences, cont.

- Startup companies usually grant ISOs to employees
- AMT can be significant disadvantage where the spread value on exercise is substantial
  - But AMT rate is lower than ordinary income tax rate on NSO
- Tax deduction on disqualifying disposition but not on qualifying disposition
- Many startups have net operating losses that minimize the value of a tax deduction for options
- Failure to withhold on NSO exercise can result in penalties for the startup

Restricted Stock

- Restricted stock is stock that is subject to certain contractual restrictions on its ownership, typically including:
  - Restrictions on transfer or resale
  - The company's right to repurchase the stock upon the employee's termination of employment
- On the date restricted stock is granted, the employee becomes the owner of record of the restricted stock

Restricted Stock, cont.

- Restricted stock vests (lapse of repurchase right) based on continued service or employment
- Vesting period is typically 4 or 5 years, with a one year cliff followed by ratable monthly vesting
- The repurchase price for the unvested shares is typically:
  - The original cost of the equity, or
  - The lower of the original cost or the FMV on the date of termination

Restricted Stock: Tax Consequences

- No tax on grant if unvested, but:
  - In the year of vesting, the employee must include as ordinary income the excess of the FMV on the date of vesting over the amount paid for the stock on the date of grant, if any (spread)
- For a startup company employee, paying tax as the shares vest may be impossible financially if the value of the shares significantly increases
- If employee files an 83(b) election, employee is taxed on spread at grant rather than spread on each of the vesting dates
  - 83(b) election is the sensible choice if value is low and no liquidity
- 83(b) election should be filed even if the spread at issuance is zero, so as to prevent future appreciation being characterized as ordinary income

Restricted Stock: Tax Consequences, cont.

- Restricted stock awards are wages subject to withholding by the company
- If the employee fails to file a Section 83(b) election at grant, then on each vesting date the company must collect income and employment taxes and remit to the IRS and state tax authority
- Company must receive proof of timely filing – lack of proof leads to problems in acquisitions

Restricted Stock: Tax Consequences, cont.

- Generally, the company is entitled to a tax deduction in the same amount, and at the same time, that the employee recognizes ordinary income
- Therefore, if an employee files a Section 83(b) election, the company can deduct the award as a compensation expense at the time of grant, rather than waiting until vesting

Restricted Stock Units

- An RSU is the right to receive from the company, after vesting, a specified number of shares of common stock
- RSUs can be settled in cash, but this is not common for startup companies
- If the employee fails to satisfy the vesting requirements, the RSU is forfeited
- If the employee satisfies the vesting requirements, the company issues shares of common stock following the vesting date (settlement)

Restricted Stock Units, cont.

- A holder of an RSU is not the beneficial owner of the underlying shares
- Property is not transferred at the time of grant and the RSU is not taxed until the RSU vests and is settled
- Settlement can be delayed beyond the vesting date
  - But, RSUs could be subject to Section 409A and there could be severe tax consequences if RSUs are subject to Section 409A but do not comply with its complex rules
- RSUs often cover fewer shares than option awards
  - Because retain some value unless stock price goes to zero

RSUs: Tax Consequences

- RSUs that are either exempt from or comply with Section 409A are generally taxed at ordinary income rates on settlement
  - Any payment of cash or stock on settlement is characterized as gross income and is subject to income tax at ordinary rates
- Employer must withhold or collect the taxes on settlement
- A subsequent sale of the shares is eligible for LTCG if the shares are held for 1 more year

RSUs: Tax Consequences, cont.

- Employment taxes, including FICA and FUTA, are due on vesting of the RSU
- Under a nonduplication rule in the Code, since the RSUs are taken into account for FICA and FUTA purposes at vesting, the value of the RSUs is not subject to FICA or FUTA taxes again when the RSUs are actually settled
- The amount includible in income is based on the value on vesting for FICA and FUTA purposes and the value on settlement for income tax purposes

RSUs: Tax Consequences, cont.

- No 83(b) election is possible for an RSU because property is not considered to be transferred at the time of grant
- Long term capital gain treatment is possible only on the subsequent increase in the value of the shares after settlement
- Generally, the company is entitled to a tax deduction in the same amount, and at the same time, that the employee recognizes ordinary income

Other Issues to Consider When Granting Equity

Scope of Equity Program

- Equity awards are used by startup companies to attract, retain, and motivate employees
- Prevalence of each type of award

Section 409A and Valuation Issues

- For a stock option to be exempt from Section 409A, the exercise price must be at least equal to the FMV of the stock at the time of grant
- Startups can establish a defensible FMV by using an IRS-approved valuation method
- Generally, option must be granted by the service recipient or its parent. Beware of grants by brother-sister entities.

Section 409A and Valuation Issues, cont.

- Severe tax penalties under Section 409A for non-exempt, non-compliant stock option:
  - Optionee recognizes taxable income equal to the untaxed spread value as the option vests and remains outstanding (the optionee is taxed on income the optionee does not actually receive from shares that may never be saleable)
  - Optionee pays an additional 20% federal tax, in addition to regular federal income and employment taxes. May also be state taxes.
  - Employer must withhold income and employment taxes (but not the additional 20% tax)

Section 409A and Valuation Issues, cont.

- How to determine the FMV of a share of illiquid stock of startup
- FMV of the stock of a company that is not readily tradable on an established securities market is determined by the consistent application of a reasonable valuation method
  - Whether method and application are reasonable is determined based on facts and circumstances
- Section 409A offers safe harbor valuation methods:
  - Independent appraisal (most common)
  - Formula valuation (not used by startup companies)
  - Startup company valuation

Section 409A and Valuation Issues: Independent Appraisal

- Venture-backed companies routinely rely on professional independent appraisals to determine FMV
- Can rely on an independent valuation for up to 12 months
  - Unless there are intervening events that would materially impact the FMV (for example, a financing or receipt of a term sheet for an acquisition)

Section 409A and Valuation Issues: Startup Company Valuation

- Valuation by internal expert
- Method is rarely used because:
  - Must memorialize the analysis in writing (burdensome)
  - The appraiser must have significant experience, education, and training (for example, 5 years of valuation-like experience)
  - Fear of expositing the company's internal finance experts to liability

Section 409A and Valuation Issues: Burden of Proof

- Consistent use of a safe harbor valuation method shifts the burden of proving that the FMV determination is unreasonable to the IRS
  - IRS would have to prove that the FMV value determination is grossly unreasonable

Relevant Practical Law Resource

- Choosing the Right Type of Equity Compensation for Startup Company Employees
- Determining Fair Market Value of Equity Awards under Section 409A
- Overview of the Taxation of Equity Compensation Awards
- Startup Equity Awards: Securities Law Considerations
- Drafting an Equity Incentive Plan for a Private Company
- Equity Incentive Plan (Private Company)

These relevant resources are available with a free, no-obligation trial to Practical Law. Visit Practicallaw.com and request your free trial today.

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Questions