

# Executive Compensation & Stock Options: Compensation Issues in a Start-Up Environment

Presented By:

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# Overview

- **Private Company Stages**
- **Equity Plan Adoption**
- **Equity Award Features**
- **Commonly Used Private Company Awards**
- **Special Situations**

# Private Company Stages

- **Early:** The company has been formed, but basically the company is only a concept and an entity. The Company has no revenues, no assets, and only a product in development. Typically, the company has little or no funding, but it may have completed a small seed round. The fair market value of a share of company stock is usually minimal and may even equal par value.

# Private Company Stages Continued

- **Mid-Stage:** the company generally has one or more products and revenues, although it often is not yet profitable, and it usually will have completed one or more rounds of financing from investors. The value of a share of company stock is quite variable, but there is at least some value and often the value per share may be a dollar or more.

# Private Company Stages Continued

- **Advanced:** The company has products and revenues, is generally profitable, and it has typically completed more than one round of financing. The value of a share of company stock varies, but often the value per share is significant.

# Equity Plan Adoption

- The equity plan should be adopted by both the board and the shareholders.
  - ISO Regulations require shareholder approval (technically, within 12 months before or after approval by the board. Don't go there, just get it when the plan is adopted for private companies). Must include a definite and determinable number of shares under ISO rules.
  - Must be reapproved if shares are added or eligible recipient class changed.

# Equity Compensation Instruments

- The basic tools for giving equity incentives to employees are:
  - **Restricted Stock.** These grants of company stock are subject to “vesting” so they are considered to be restricted awards.
  - **Stock Options,** both incentive stock options (“ISOs”) and nonstatutory stock options (“NSOs”)
  - **Restricted Stock Units (“RSUs”)**

# Restricted Stock

- **Restricted Stock Characteristics:**
  - Usually granted during a company's early stages.
  - Purchased shares are subject to vesting restrictions (i.e. unvested stock may be repurchased by company at cost upon termination of employment).
  - Stock usually held in escrow until it vests.
  - Taxed under Section 83 of the Code.
  - Section 83(b) election must be filed within 30 days of purchase.



# Restricted Stock Continued

- **Restricted Stock Tax Treatment**
  - transfer of property in connection with the performance of services
- **83 (b) not filed:**
  - If Section 83(b) election is not filed, the difference between the purchase price and FMV at the date of vesting is compensation income.
- **83 (b) timely filed:**
  - If Section 83(b) election is filed, the difference, if any, between the purchase price and FMV (on the vested and unvested shares) is compensation income on the date of purchase.
- **Withholding is required on compensation income if purchaser is an employee.**
- **Generally exempt from Section 409A.**

# Restricted Stock Continued

- **83(b) Election Requirements:**
  - **Must be filed within 30 days of the date of purchase.**
  - **Mailed to the IRS center that the taxpayer's tax return would be sent to.**

# Restricted Stock Continued

- **Tax Considerations for the 83(b) Election:**
  - **Ordinary Income:**
    - taxed at progressive rates of up to 37%
  - **Long Term Capital Gains:**
    - taxed at 20% for investment property held for more than one year.
  - **Employee loses if an 83(b) is filed, taxes are paid, and then stock is forfeited.**

# Restricted Stock Continued

- **Restricted Stock Advantages:**
  - A full value award.
  - Capital gains tax treatment.
  - Potential for zero ordinary income treatment at early stages of company.
  - No independent valuation needed (unlike stock options).
  - Par value payable in services.

# Restricted Stock Continued

- **Restricted Stock Disadvantages:**
  - Award recipient becomes a shareholder.
  - If granted when the company has value in the stock, then there will be ordinary income tax:
    - at vesting if no 83(b) is filed, or
    - at grant if an 83(b) is filed.
  - The ability to decide when to have the income event is not as flexible as stock options, and there can be liquidity concerns for employees.

# Stock Options

- **An option is a contract between the optionee and the company, giving the optionee the right to purchase a specified number of shares at a fixed price during a specified period of time.**

# Stock Options Continued

- **Why options are valuable:**
  - Optionee has the right to purchase the shares at a fixed price (the “exercise price”) over the term of the option.
  - If the shares increase in value, optionee may still purchase the shares at the exercise price.
  - If the shares decrease in value, optionee is under no obligation to purchase the shares.

# Stock Options Continued

- **Terminology: Five Important Events in an Option's Life**
  - **Grant:** board acts granting optionee an option.
  - **Vesting:** the right to exercise an option is earned through continuing services or a specified vesting event.
  - **Exercise:** when an optionee exercises the option by notifying the company and paying for the stock.
  - **Sale of Stock:** securities laws and plan provisions generally limit pre-IPO transferability; generally freely tradable post-IPO but usually subject to 6 month lock-up immediately following IPO.
  - **Termination:** generally three to six months after termination of status as an employee for vested options, or 1 year after death or disability. Generally, an option cannot have a term more than 10 years from date of grant.



# Stock Options Continued

- The types of stock options:
  - An NSO is any option that does not qualify as an ISO.
    - No tax at grant.
    - At exercise, ordinary income = “spread.”
    - Spread is subject to tax withholding and W-2 reporting for employees.
    - Sale - capital gain/loss.
  - long-term capital gain if shares are held for > 12 months.

# Stock Options Continued

- An ISO is an option that is eligible for more favorable tax treatment than other options (NSOs).
- Key Concepts:
  - No tax at grant.
  - No ordinary tax at exercise (purchase).
  - Alternative minimum tax (“AMT”) applies at exercise.
  - Sale or other disposition triggers income.
  - Tax consequences differ depending on whether disposition is “qualifying” or “disqualifying.”

# Stock Options Continued

- **ISO Applicable Holding Periods:**
  - 2 years from ISO grant AND
  - 1 year from ISO exercise (purchase).
- Meeting both of these holding periods results in a qualifying disposition (capital gains on the difference between exercise and sale prices).
- Failure to meet both of these holding periods results in a disqualifying disposition (normally income on the spread at exercise and capital treatment for difference between exercise FMV and sales price).

# Stock Options Continued

- **ISOs must be granted pursuant to a written plan that:**
  - sets forth the number of ISO shares that may be issued under plan,
  - states the class of employees eligible to receive options, and
  - is approved by majority of S/Hs w/in 12 months of Board adoption.
  - Exercise price must be 100% of FMV on date of grant (110% FMV for 10% S/Hs).
  - Can only be granted to employees of company (or parent).

# Stock Options Continued

- **Additional ISO Requirements:**
  - **Maximum term of 10 years (5 yrs for 10% S/Hs).**
  - **Must be exercised within 3 months of termination (12 months if death or disability).**
  - **\$100,000 RULE**
    - The FMV of ISO shares (defined on grant date) that become exercisable for first time in any calendar year may not exceed \$100,000.
    - To extent this rule is exceeded, excess shares are taxed as if granted pursuant to an NSO.

# Stock Options Continued

- **Establishing Fair Market Value for Options:**
  - For private companies, the rule is that the price must be determined by the “reasonable application of a reasonable valuation method.”
  - The analysis will be a facts and circumstances analysis, but the IRS factors to be considered include: the value of tangible and intangible assets, the value of anticipated cash flows, the objectively determinable value of stock in substantially similar corporations, recent arm’s length transactions, control premiums, and discounts for lack of marketability.

## Stock Options Continued

- Private company valuations are not reasonable if they do not take into account all available information material to the value of the corporation.
- Certain valuation methods provide a safe harbor presumption that the valuation is reasonable, which would mean that the IRS would have to show that the valuation was grossly unreasonable in any challenge.

# Stock Options Continued

- The methods that provide a safe harbor are using a valuation formula, a written valuation of an illiquid start-up corporation, and an independent valuation. Almost all safe harbor valuations are now independent valuations, and market practice for private companies is to obtain such a valuation as soon as the company has funds to pay for one.
- A valuation is no longer reasonable after the date when it fails to account for information that materially affects the value, or 12 months following the date of the valuation whichever is first.



# Stock Options Continued

- **Date of Grant Considerations:** Under Code Section 409A, the date of grant of a stock right can be no earlier than the date on which the corporation completes the corporate action necessary to create a legally binding right.
  - The recipient and maximum number of shares must be specified; and
  - The minimum exercise price and class of underlying stock must be specified.

# Stock Options Continued

- **Service Recipient Stock:**
  - The stock must be Common Stock under Code Section 305.
  - The stock cannot have a preference for distributions.
  - The stock cannot be subject to a mandatory repurchase obligation or a put or call right based on a measure other than fair market value.
  - The stock must be from a corporation that is an “eligible issuer.”

# Stock Options Continued

- **Stock Option Advantages:**
  - Ability to pick date for tax event for optionee.
  - Exercise starts the capital gains holding period.
  - Generally a larger number of shares are awarded than for restricted stock or restricted stock unit awards giving a greater upside for stock that appreciates substantially.

# Stock Options Continued

- **Stock Option Disadvantages:**
  - Practical experience leads us to say that few optionees get capital gains treatment on either ISOs or NSOs.
  - Requirement for funds for exercise price and withholding obligation for NSOs.
  - If the company stock price falls, options can be underwater and lose incentive effect.
  - For ISOs, the company can lose a deduction for any options that meet the holding periods and other requirements for a qualifying disposition.

# Restricted Stock Units (“RSUs”)

- **RSUs are a promise to issue shares at a date in the future if certain vesting conditions are met.**
- **Conditions can be continuation in service for a period of time or achievement of performance goals.**
- **No payment is required to be made for the shares, but as they are compensation the employee-recipient will be taxed at ordinary income rates upon delivery of the shares and must pay to the issuer any taxes the issuer is required to withhold or agree to a net reduction of shares. “Net settlement” is typical.**

# Restricted Stock Units Continued

RSU	Option
No payment required	Payment of FMV-based exercise price
Withhold employment taxes on vesting and income taxes on delivery of shares	Withhold income and employment taxes on exercise
Timing of taxation cannot be controlled by holder	Timing of taxation (exercise) is controlled by holder
Few shares required, relative to options, to deliver equivalent value	More shares required, relative to RSUs, to deliver equivalent value

# Restricted Stock Units Continued

- **RSU Advantages:**
  - No employee investment required.
  - Promotes stock ownership, and arguably, better alignment with stockholders.
  - Consumes fewer shares than appreciation vehicles (such as options).
  - Consistent retention value because always “in-the-money.”
  - May result in lower financial accounting compensation expense compared to stock options because higher perceived value allows grant of fewer shares (usually granted at a ratio of 3 or 4 to 1 from comparable option grant).

# Restricted Stock Units Continued

- **RSU Disadvantages:**
  - May be viewed negatively by shareholders unless performance conditions attached.
  - Less “leverage” than options.
  - Employee has less flexibility over timing of taxation (compared to stock options).
  - Tax withholding due at vesting (liquidity requirement).
  - Must be carefully drafted to avoid problems under Code Section 409A.



# Putting the Pieces Together

- What is the most common equity compensation structure to use for an early stage company?
  - Restricted Stock for founders.
  - Stock Options for later employees.

# Putting the Pieces Together

- What is the most common equity compensation structure to use for a mid-stage company?
  - Stock Options, both ISOs and NSOs.
  - Restricted Stock for some key employees.

# Putting the Pieces Together

- **What is the most common equity compensation structure to use for a mature private company?**
  - **Stock Options.**
  - **Restricted Stock Units.**
  - **A combination of full value and appreciation awards is common.**

# Cash Based Bonus Plans

- **Bonus plans are plans designed to pay out in cash, not stock:**
  - Commonly called phantom stock plans, change of control bonus plans, synthetic equity.
  - Properly drafted, these plans should not be securities.

# Cash Bonus Plans Continued

- Cash based plans must comply with or be exempt from Code Section 409A.
  - The most common exemption is “short term deferrals” which requires a substantial risk of forfeiture (services) until a “vesting” event, then pays out by March 15 of the year following the year of vesting. This is “present to win,” most common, and probably a concern if not designed this way.

# Cash Bonus Plans Continued

- If a cash bonus plan is not “present to win” exempt from Section 409A, then:
  - The plan must be made to comply with Section 409A which requires a written plan document and:
    - Only permitted payment events using Section 409A compliant definitions: death, disability, fixed payment date, separation from service, lapse of a substantial risk of forfeiture, change of control, and unforeseen emergency (rare, technical), and only permitted payment schedules.
    - Very inflexible which is why we generally recommend against these for private companies.

# Special Situations

- One administrative issue to watch out for is a “modification,” which is defined slightly differently under Code Section 424 (for ISOs) and Code Section 409A:
  - Section 409A defines a modification as “any change in the terms of a stock right ... that may provide the holder with a direct or indirect reduction in the exercise price.” It does not matter whether the holder actually benefits from the change.
  - Section 424 defines an ISO “modification” as a change which provides an additional benefit. The interpretations here are very subtle.

## Special Situations

- **Focusing on Code Section 409A modifications, if a stock right is modified, it is treated as a new grant on the day of modification. The stock right would have to satisfy all of the conditions necessary to be exempt from Code Section 409A on the date of modification, so *any option that is priced at less than fair market value on the date of a modification will not be an exempt stock right*. Modifications include: a reduction in the exercise price (other than pursuant to a stock split, dividend, or other corporate transaction), allowing the discretion to provide added benefits that would result in a modification themselves, and making changes in the underlying stock that increase the value of the stock.**



# Special Situations

- **Certain actions are not treated as modifications under the regulations:**
  - Shortening the period during which the right is exercisable;
  - Adding the right to have shares withheld or to tender previously acquired stock to facilitate paying the exercise price; and
  - Accelerating or delaying the vesting or exercisability of a stock right within the original term.

## Special Situations

- **Actions that are considered “extensions” of stock rights will cause the stock right to be considered to have had an additional deferral feature from the date of grant, and so the stock right would have been subject to Code Section 409A from the date of grant. This would not allow an opportunity to modify the award to change other terms, such as adding a fixed exercise date, at the same time.**

# Special Situations

- Except when a stock right is under water, any of the following could be treated as an extension:
  - Converting or exchanging a stock right for a legally binding right to compensation in a future year;
  - Adding any feature of deferral;
  - Allowing discretion to provide added benefits if the added benefit would be a modification; and/or
  - Permitting any additional time in which to exercise beyond the original term of the stock right.

# Special Situations

- **Option Repricings:**
  - Treated as modifications.
  - Allowed, provided that they don't fail requirements on date of modification.
  - Serial repricings a potential issue.

# Questions and Disclaimer

## Questions?

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