



WILMER CUTLER PICKERING HALE AND DORR LLP

WEBINAR

# *QuickLaunch University: Understanding Startup Equity Compensation*

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WEBINAR

# *Speakers*



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## *What We'll Cover Today*

- What equity compensation is, why it is used and the forms it can take
- Most common types of equity compensation
  - Restricted stock (and Section 83(b) Elections)
  - Stock Options (and Section 409A)



## *Why Have Equity Compensation?*

- Conserves cash
- Gives service providers potential for huge upside (e.g. upon sale, via stock market appreciation)
- Allows smaller companies to compete for talent with larger/established companies
- Provides mechanism for employee ownership stake in company/aligns shareholder and employee interests



## *Common Forms of Equity Incentives*

- Restricted Stock
- Stock Options
  - Incentive Stock Options
  - Nonstatutory Stock Options



## *Vesting Schedules*

- Can be time based or performance-based.
- **Restricted Stock Example:** 100 shares of Restricted Stock vests over 4 years in equal annual installments. On each vesting date, recipient holds 25 shares free and clear.
- Vesting schedules can be accelerated under a Stock Incentive Plan, the award agreement, an employment agreement or offer letter, or the terms of a transaction.



## *Restricted Stock*

- What is restricted stock?
  - Restricted stock vs. restricted stock units
- Taxation of restricted stock (see next slide)
  - Section 83(b) election
  - Section 409A issues
- Accounting issues for restricted stock
  - FASB ASC Topic 718
- Imposing restrictions on already owned stock
- When do you use restricted stock?



## *Taxation of Restricted Stock*

- 83(b) Election Timely Filed
  - **Date of Grant:** Ordinary income = FMV of stock – purchase price (if any)
  - **Vesting Date:** No income
  - **Sale:** Capital gain or loss = Sale Price – Grant Date FMV
- 83(b) Election not Filed
  - **Date of Grant:** No income
  - **Vesting Date:** Ordinary income = FMV of stock – purchase price (if any)
  - **Sale:** Capital gain or loss = Sale Price – Vesting Date FMV



## *Stock Options*

- What is a stock option?
- Benefits of stock options
- Either Incentive Stock Option (“ISO”) or Nonstatutory Stock Option (“NSO”)
- Accounting for stock options
  - FASB ASC Topic 718
- When do you use options?



## *Incentive Stock Options*

- Must comply with tax rules
  - Granted under shareholder approved plan
  - Option holder must be an employee
  - Exercise price must equal FMV at time of grant
  - \$100,000 limitation
- Generally more favorable tax benefits to employees as compared to nonstatutory stock options



## *Nonstatutory Stock Options*

- No specific tax rules
  - Does not have to be granted under a plan, shareholder-approved or otherwise
  - Can be issued to any service provider (i.e., employee, director, independent contractor)
- **BUT**, Section 409A requires a FMV exercise price
- Generally less favorable tax treatment for employees as compared to ISOs



## *When Does An ISO Become An NSO?*

- Failure to meet ISO requirements
  - Award made to non-employee
  - Inducement grant (not made under a SH-approved plan)
  - Grants in excess of \$100K limit
- Amendment of ISO
  - Extend post-termination exercise period
  - Early exercise
- Holder terminated employment more than 3 months pre-exercise (death/disability, 1 year)
- Cash-out of awards



## *Taxation of ISOs*

- **Grant:** No tax
- **Vesting:** No tax
- **Exercise:**
  - Ordinary (Compensation) Income: None
  - AMT Income: FMV on exercise date – exercise price
- **Sale:**
  - If shares held until the date that is at least two years from grant date and one year from exercise date, all income is LTCG
  - If held for a lesser period (i.e., if there's a “disqualifying disposition”), the lesser of spread on exercise date and profit (i.e., sale price – exercise price) is ordinary income; excess (i.e., sale price – FMV on exercise date) is capital gain



## *Taxation of NSOs*

- **Grant:** No tax
- **Vesting:** No tax
- **Exercise:**
  - Ordinary Income in Year of Exercise: FMV on exercise date - exercise price
  - Income and employment tax withholding required for employees
- **Sale:**
  - Capital gain (or loss): Sale price - FMV on exercise date



## *What is Fair Market Value?*

- Historically, option exercises prices were established based on the Board's determination of FMV
  - Rules of thumb based on rounds of financing
- Today, valuations by independent appraisers are common because of Section 409A
  - Valuation must take into account all relevant qualitative and quantitative factors (value of tangible and intangible assets, discounted cash flow, recent transactions in the stock, values of comparable companies, etc.)



# *Restricted Stock vs. Options*

Restricted Stock	Options
<ul style="list-style-type: none"> <li>• Actual ownership stake in the Company</li> </ul>	<ul style="list-style-type: none"> <li>• Only convey the right to become a shareholder in the future</li> </ul>
<ul style="list-style-type: none"> <li>• Often (but not always) requires any outlay of some cash up front</li> </ul>	<ul style="list-style-type: none"> <li>• Optionholder controls when investment is made</li> </ul>
<ul style="list-style-type: none"> <li>• Almost always has value</li> </ul>	<ul style="list-style-type: none"> <li>• May not have value (if exercise price &gt; FMV of underlying stock)</li> </ul>
<ul style="list-style-type: none"> <li>• Vesting Schedule: Schedule on which stock ceases to be forfeitable or corporation loses its ability to repurchase the stock.</li> </ul>	<ul style="list-style-type: none"> <li>• Vesting Schedule: Schedule on which a holder can first exercise a portion of the option.</li> </ul>
<ul style="list-style-type: none"> <li>• Upon a termination of services, Company has to affirmatively act to get the stock back.</li> </ul>	<ul style="list-style-type: none"> <li>• Upon a termination of services, optionholder has to affirmatively act to exercise the option (to the extent vested) and purchase stock before expiration.</li> </ul>
<ul style="list-style-type: none"> <li>• Tax treatment dependent on whether an 83(b) election was filed. If it is, compensation income is determined at grant; CGHP begins day after filing. If not, compensation income determined on each vesting date; CGHP begins day after vesting. (But public co recipients rarely file 83(b)s).</li> </ul>	<ul style="list-style-type: none"> <li>• Tax treatment dependent on whether option is an ISO or NSO. CGHP begins only after the award is exercised.</li> </ul>



## *Summary*

- Restricted stock
  - Best tax benefits for founder and early employees
- Stock options
  - ISOs generally for employees to extent of limit
  - NSOs for directors, non-employees
- Deferred compensation – Section 409A issues



# Questions?



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