

Equity Compensation For Founders and Employees

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Suits and Ties?

Here's why:

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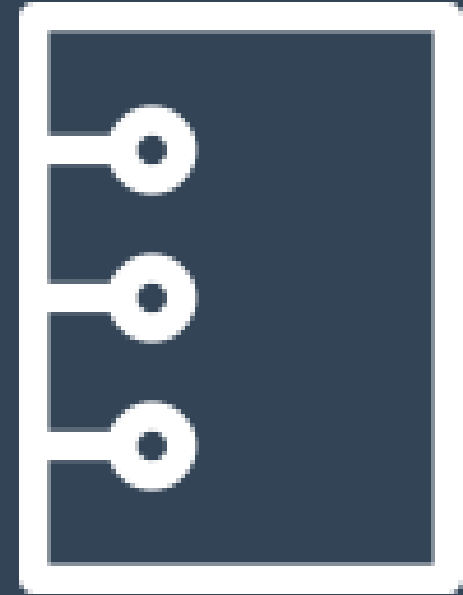
Cutting edge!

DISCLAIMER

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Agenda

1. Introduction / Foundation
2. Types of Equity Compensation
3. Company Example



Why Equity Compensation?

- Attracting “A” Level Talent
- Retaining “A” Level Talent
- Aligning Incentives – Growth!
- Saving \$\$\$



The Foundation



- **IRC Section 83**
 - Section 83(a)
 - Section 83(b)

Choice of Entity

- Limited Liability Company (LLC)
- Corporation
 - C Corporation
 - S Corporation



LLC Equity Compensation



- Capital Interest
- Profits Interest
- Restricted Interests
- Options

CAPITAL INTERESTS

- Definition – an interest that entitles the holder to a distribution of an allocable share of the proceeds if the LLC's assets were sold at FMV in liquidation of the LLC immediately after the grant.
- Tax Consequences –
 - Recipient = taxable event
 - LLC = deduction equal to amount recognized by recipient
 - Unintended Capital Shift

PROFITS INTERESTS

- Definition – Profits interest defined in IRS revenue rulings
 - Profits Interest must be granted for services.
 - The interest must not give the holder any right to distributions if the business were sold for FMV immediately after grant and proceeds were distributed in complete liquidation of the company.
 - The interest cannot relate to substantially certain income.
 - Interest must be retained for two years

PROFITS INTERESTS

- Tax Consequences –
 - No tax at grant or vesting if interest is held for at least two years and both recipient and company treat the interest the same for federal income tax purposes
 - E.g., allocations of income and loss and distributions of profits
 - Some recipients make a protective 83(b) election
 - Capital gain/loss on sale (after 2 years, except for hot assets)
 - No cost to exercise

Capital Interests vs. Profits Interest

- Assume Company value at time of grant of interests = \$5,000,000
- Assume grant of interest = 5%
- Assume Company is subsequently sold for \$20,000,000

	<u>Capital Interest</u>	<u>Profits Interest</u>
Value of Interest at Grant	\$ 250,000	\$ 00
Value of Interest at Sale	\$1,000,000	\$750,000

- Although Profits Interest only gets a share of the vaolue “ups,” it will also receive 5% of all income/loss allocations and cash distributions from operations.

RESTRICTED INTERESTS

- Restricted Capital Interest – a capital interest that is non-transferable or is subject to a substantial risk of forfeiture (SROF) is not taxable until transferable and the SROF lapses (unless an 83(b) election is made).
- Contingent Profits Interest – Rev. Proc. 2001-43

LLC OPTIONS

- No such thing as ISOs for LLC Options
- Treated like NQSOs for tax purposes
 - No tax on grant (unless has readily ascertainable FMV).
 - Taxed at exercise (FMV at exercise over exercise price) at ordinary income rates.
 - Taxed at sale as capital gain/loss (difference between sale price and FMV at exercise)
 - Unclear whether Section 83 applies.

EMPLOYEE VS. OWNER

Employee

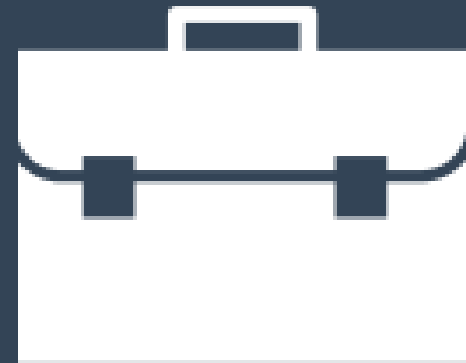
- Withholding on Wages
- W-2
- No losses
- Ordinary income

Owner

- Withholding on Distributions
- K-1
- Pass-through losses
- Pass-through character of income

Corporate Equity Compensation

- Restricted Stock
- Stock Options (NQSOs and ISOs)
- Restricted Stock Units (“RSUs”)
- Stock Appreciation Rights
- Phantom Stock



RESTRICTED STOCK

- Substantial Risk of Forfeiture (“SROF”)
- No rights as a stockholder until the SROF lapses.



RESTRICTED STOCK

- SROF Examples:
 - Employed full-time for specified period
 - Performance-based conditions (e.g., development or earnings milestones)
- Acceleration:
 - Change in Control



RESTRICTED STOCK

- Taxation of Restricted Stock.
 - General Rule – Federal income tax and FICA tax apply when SROF lapses.
 - IRC Section 83(b) Election – Recipients elect to take grant date value of stock into income for federal income tax purposes; applies also for FICA tax purposes.

RESTRICTED STOCK

- Section 83(b) Election.
 - Timing – filed within 30 days following grant date.
 - Value – Need to determine fair market value of stock as of grant date.
 - No longer need to attach to federal income tax return.



STOCK OPTIONS

- Two Types of Options:
 - Nonqualified Stock Options (“NQSO”); and
 - Incentive Stock Options (“ISO”)



STOCK OPTIONS

- NQSO Attributes.
 - No tax on grant (unless has readily ascertainable FMV)
 - Taxed at exercise (FMV at exercise over exercise price) at ordinary income rates and Company gets deduction
 - Taxed at sale as capital gain/loss (difference between sale price and FMV at exercise)
 - Ordinary income tax rates (highest = 39.6%)
 - No 83(b) election unless “early exercise” is permitted or the NQSO has a readily ascertainable FMV
 - Early exercise permits optionee to exercise non-vested shares
 - 83(b) election must be made within 30 days after exercise date
 - May be granted to employees and non-employees

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STOCK OPTIONS

- ISO Attributes.
 - No tax at grant
 - No tax at exercise (unless AMT applies).
 - Taxed at sale as LT capital gain/loss if holding period met, otherwise ST capital gain/loss taxed at ordinary income rates
 - Shares must be held for 2 years from grant date & 1 year from exercise date
 - No 83(b) election unless “early exercise” is permitted
 - \$100,000 rule applies
 - Must satisfy approval requirements
 - Must be granted to an employee of issuer (or 50% parent/subsidiary).

Comparison Chart

	Stock Options	Restricted Stock	Restricted Stock Units
Definition	The right to purchase shares in the future at a price specified on the date of the grant	Shares granted subject to certain restrictions	Units giving the right to receive shares, subject to certain restrictions
Value	Depends on increase above exercise price	Depends on stock price at vesting	Depends on stock price at vesting
Payment	Payment of exercise price	No payment to receive shares	No payment to receive shares
Voting Rights/ Dividends	Upon exercise	Yes, even during vesting period	No, but company can choose to give dividend equivalent bonus
Tax	Taxable at exercise for NQSOs & ISOs and at share sale for ISOs	Taxable at vesting (unless 83(b) is filed)	Taxable at vesting
Where used	Early stage, high-growth startups	Co-founder arrangements	Mature companies/late stage startups with liquid stock
Why used	Significant upside as valuation rises; ability to time taxation for employees	Low company valuation when stock distributed, so lower downside risk	Taxes due at vesting, but more mature stock sale can support payment required

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FACTS

- SAAS Company – Software for Chiropractor Evaluations
- Two Founders – Abby and Ben
- Company wants to hire CTO, CMO, CFO, and attract other non-executive employees
- Company needs to raise money to hire

Formation of Company

Corporation

- Articles of Incorporation
- Bylaws
- Shareholder Agreement

LLC

- Articles of Organization
- Operating Agreement

Founder Shares/Interests

Corporation

- Planning Ahead
- What is “Founder’s Stock”
- Vesting?
- Section 1202 Stock

LLC

- Planning Ahead
- In some ways easier than a corporation
- Dealing with pie

Hiring Executives

Corporation

- Type of Compensation
- Application of Section 83

LLC

- Type of Compensation
- Application of Section 83

Employees

Corporation

- Type of Compensation
- Vesting Schedule
- The “Cliff”

LLC

- Type of Compensation
- Vesting Schedule
- Book-ups

Employer Protections

- Transfer Restrictions
- Right of First Refusal (ROFR)
- Repurchase Rights
- Termination Provision
- Drag-Along Rights



Employee Considerations

Corporation

- Accelerated Vesting
- What are you really getting?

LLC

- Mandatory tax distributions
- Member vs. Employee Issues

Thank You

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