

**Equity Incentives – Business, Tax, and Other Practical Considerations**

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**Circular 230 Disclaimer**

Any tax advice contained in the body of this presentation was not intended or written to be used, and cannot be used, by the recipient for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law.



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**Overview**

- Terminology
- Equity Incentives
- Points to Consider
- Tax Considerations – 409A and 83(b)
- Business Considerations
- Conclusion
- Questions



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**Terminology**



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**Words to Know:**

- ISO
- Nonqual
- Vested/Unvested
- Spread
- Under Water
- In the Money
- Phantom Equity
- Service Units / Profits Interest
- Strike/Exercise Price
- Deferred Compensation
- Substantial Risk of Forfeiture



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**Equity Incentives**



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### Common Choices

- Stock Options
- Phantom Equity
- Service Units/Profits Interest
- Restricted Stock
- Promises



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### Stock Options

- ISOs
- Non Quals



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### ISOs in General

- Defined in Code Section 422
- Code Section 421(a) application
- Capital gains.....maybe
- No employer deduction.....likely



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### ISO Requirements

- Employment
- Plan Requirements
  - Written Plan
  - 10 years
- Valuation
- Transfers
- Cannot own more than 10% interest – unless:
  - 110% valuation
  - 5 year term
- \$100K Limit

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### Nonquals Generally

- Stock options other than ISO
- Ordinary Income.....yes
- Employer deduction.....yes
- Less strict than ISO, generally
- Majority of stock options in private companies

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### Nonquals in Action

- W-2 Income on Spread
- Payment of Exercise Price
- Cashless exercise
- Holding periods

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### Phantom Equity

- Structure
- Participate in appreciation
- Rights and potential issues
  - Distributions
  - Capital Restructure



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### Service Units/Profits Interest

- Rev Proc. 93-27 and 2001-43
- No capital accounts
- Participation in growth
- Liquidation/Distribution
- Member rights
- 83(b) election?



14

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### Restricted Stock

- Structure
- Vesting
- Voting
- Dividends
- 83(b)?



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**Promises**

- Employment agreement
- Napkins
- Promises made in times of crisis

BE CAREFUL!!!



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**Points to Consider**



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**Nuts and Bolts**

- Administration
- Valuation
- Role of professional advisors
- Structure of Plans and Grant Agreements
- Rights



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**Tax Considerations – 409A and 83(b)**



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**Tax Considerations**

- 409A
- 83(b)
- Ordinary Versus Capital Gain
- Deductions
- Withholding Taxes



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**409A – 30,000 Feet**

- Be careful
- Comply
- 20% extra tax
- Loss of deduction



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**409A: Application**

- Any “vested right” to taxable compensation in a future year
- Must either recognize income in year of vesting or make deferral election UNLESS
  - Exclusion applies (e.g. short term deferral)
  - Permitted distribution (e.g., set date, death or disability, termination, change of control, emergencies)
- Acceleration not permitted
- Ability to re-negotiate very difficult



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**409A: Equity Compensation**

- Broad Exceptions for nondiscounted grants
- Must generally be granted at fair market value



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**409A: Valuation**

- Must be “reasonable”
- Safe Harbors
  - Independent valuations
  - Startup “insider” valuations
- Role of Professional Advisors



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**409A: Modifications and Extensions**

- Treated as new grant
- Generally cause automatic violation



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**409A: Arrangements and Plans**

- Definition of "Deferred Compensation Plan"
- Equity Incentives
- Employment Agreements/Arrangements
- Bonus Plans
- Life Insurance
- Reimbursement of Expenses



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**409A: Risks of Violating**

- 20% additional tax
- loss of deduction
- Mad employees



27

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**83(b)**

- Elections
  - 30 days
- Potential Costs/Benefits



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**Other Tax Considerations**

- Capital Gain/W-2 Income
- Withholding Taxes



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**Business Considerations**



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**Positives**

- Retention
- Value to employees
- Incentives
- "Skin in the game"



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**Negatives**

- Reduced pie for owners
- Complications
- Potential hurdles on change of control
- Administrative expenses/difficulties



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**Conclusion**



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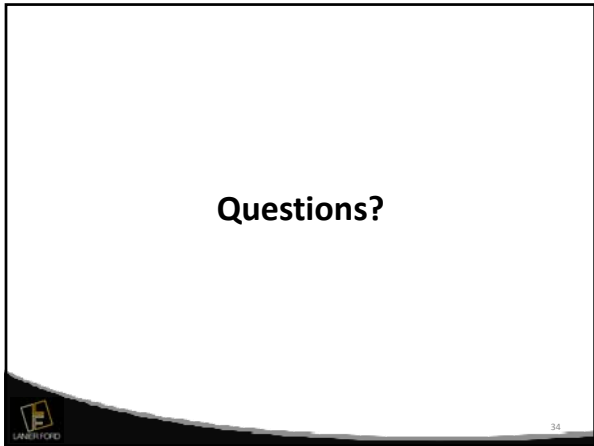
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