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How to Motivate Your Team with Equity Compensation: What Startup Companies Need to Know

By Eliza P. Shea, Andrea H. Vossler

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Cash-strapped startup companies often find themselves looking for creative ways to engage and retain qualified people. One common way is to offer different types of equity compensation.

Stock Options—commonly used, frequently misunderstood. – Most of us have heard of stock options. They give the holder the right to buy a certain number of shares of stock at a fixed price, even if the stock price rises in the future. For example, you might receive options to purchase 1,000 shares of common stock at $1.00 per share. If you decide to exercise your option to purchase those shares 5 years later when the stock is $3.00 per share, you're still able to purchase them for $1,000.

Make sure you set a reasonable value —or risk heavy tax penalties. Because startup company stock is not

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publicly traded, options must be granted at fair market value. Determining what constitutes fair market value is important for tax reasons—failure to set a value that is "reasonable" can result in heavy tax penalties. A valuation method is considered reasonable if it takes into consideration all information that is material to the value of the company. Section 409A of the Internal Revenue Code identifies three safe harbor methods for valuation—engaging a third party such as an accounting firm to do an independent appraisal is the most common one.

Don't forget about tax treatment—it's important. Stock options are classified for tax purposes as either non-qualified stock options (NSOs) or incentive stock options (ISOs). In general, they are not taxed at grant or vesting. However, they may be taxed at exercise. This is one of the important differences between ISOs and NSOs. ISOs are not taxed when an employee exercises the option to purchase shares. Using the above example, the employee would pay the $1,000 exercise price to the company, and no federal income tax on the "spread" (i.e., the difference between the exercise price and the share price at the time of exercise). NSO holders, however, pay the spread. As a result, the employee would pay the $1,000 exercise price to the company, *plus* federal income tax at his or her personal income tax rate on the $2,000 spread. Assuming a 25% personal income tax rate, that would be an additional $500. Because of this difference in tax treatment, NSO holders will generally not exercise their options until a sale event, when they would have the cash to pay both the exercise price and the tax. Unfortunately, ISOs are subject to a number of restrictions, perhaps the most significant of which is that they can only be issued to employees. For this reason, they are not used as frequently as NSOs.

Stock/Restricted Stock – The preferred award for founders and early employees. Stock and restricted stock is also granted by startup companies. Unlike options, a recipient of stock or restricted stock becomes a stockholder of the company immediately at grant. There are two main differences between stock and restricted stock: (1) restricted stock is subject to a "substantial risk of forfeiture" (which, in layman's terms, usually means a repurchase right in favor of the company), and (2) stock is taxed as compensation to the service provider at grant, whereas restricted stock is taxed as compensation to the service provider when it vests. Service providers can elect to pay taxes on the value of the restricted stock at grant rather than waiting until it vests by filing an 83(b) election with the IRS within 30 days of grant—and they often do. This is because the value of the stock (and the related tax obligation) is usually low when granted. This is one of the reasons that startups issue stock or restricted stock at the company's incorporation when the value of the company is close to zero. Typically, only founders or very early employees are issued stock or restricted stock—as the company scales, most transition to issuing options to (among other things) reduce their team's tax burden.

Phantom Stock—An alternative to stock – Some companies issue phantom stock as a way to incentivize their teams without actually giving up any equity in the company. Phantom Stock is an award whose value is linked to company stock. If you receive phantom stock, you're not issued actual shares. Instead, you receive an account credited with a certain number of hypothetical or "phantom" shares. Holders of phantom stock are not entitled to voting, dividend or other stockholder rights, however payments of the awards can be made in cash or in shares of company stock and, if paid in stock, the holder would then be entitled to voting, dividend and other stockholder rights. The value of the holder's account increases or decreases over time based on appreciation or depreciation of the company's stock and the crediting of phantom dividends. There is no transfer of property when phantom stock is granted, and no taxation until the phantom stock vests and is paid to the holder in stock or cash. Like options, phantom stock must comply with Section 409A or it will be subject to adverse tax consequences. Ordinary income is recognized upon receipt of cash or stock equal to the fair market value of the cash or stock received. If phantom stock is settled in shares, you can receive capital gain or loss treatment if you later sell your stock, as long as you've met the applicable holding period requirements.

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Profits Interests – What if you own an LLC? While stock options and phantom stock are used by corporations to incentivize their workforces, profits interests are used by LLCs to do the same. Profits Interests give the holder the right to receive a percentage of future profits of the company and are typically granted in exchange for the contribution of services. Unlike the holder of a capital interest, the owner of a profits interest has no current capital at risk in the venture and usually has no obligation to contribute funds in the future. Importantly, a holder of profits interests must be a partner or become a partner of the LLC for tax purposes. A profits interest recipient cannot be treated as an employee and cannot receive W-2 compensation.

If structured properly, the contribution of services to an LLC in exchange for a profits interest should be tax-free for the service provider and to the company at the time of grant and, if applicable, as it vests. Additionally, service providers who receive profits interests in lieu of cash compensation receive beneficial tax treatment which includes deferring income until gain is recognized by the LLC and potentially converting compensation income into preferentially taxed, long-term capital gains. The ability to do this depends on the specific circumstances. Please note that, under some circumstances, holders of profits interests may have phantom income.

There are a number of different ways for companies to attract and retain qualified personnel and the above list is only a high-level summary of what we see most frequently. We often find that deciding which makes the most sense for a particular company involves a careful analysis of the business, its structure, and the associated tax implications.

Please note that we are not providing any specific tax advice regarding any of the various forms of equity awards discussed above. The tax treatment and consequences of each type of award should be discussed with your accountant, as some may be more beneficial than others, and some may have more significant tax consequences. Additionally, please note that any startup company issuing any of the above forms of compensation to employees and consultants will have to find an exemption from registration under the Securities Act of 1933 and applicable state securities laws.

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