Motivating Employees Through Company Equity

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Presentation Outline

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I. Benefits of Employee Ownership

- Employee ownership offers attractive tax benefits to employees, employers and/or both
- It allows growing companies to compensate employees with equity or its equivalent rather than cash

Benefits of Employee Ownership
Productivity Gains

- Just as important are the productivity gains accruing to the company…
  - Studies consistently show employee ownership plus a participative management style results in companies performing better than expected
  - Neither ownership nor participation alone accomplish these significant gains
  - Companies need employees to "think and act like owners"
  - What better way to do so than by making them owners?
  - Tech firms, in particular, increasingly attract quality employees through offering company equity

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Benefits of Employee Ownership
Substantial Growth in Company Ownership

- Over the past decade, the number of companies sharing ownership with employees grew substantially:
  - According to the National Center for Employee Ownership, approximately 9 million employees participate in some 3,000 plans, up from only 1 million in 1990
  - There are approximately 11,500 ESOPs in the U.S. covering almost 14 million participants and controlling several hundreds of billions of dollars in assets
    - Of these, approximately 5% are in publicly traded companies while the remaining 95% are in closely held firms
  - The median percentage of employee ownership for private firms is about 30-40%, with about 3,000 companies now majority employee owned
  - A significant number of companies provide stock options or other kinds of individual equity to most or all employees

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Benefits of Employee Ownership
Additional Reasons to Share Company Ownership

- Employee ownership benefits owners, employees and their companies in a variety of ways
  - Aligning the interests of the employee with those of the company, thereby promoting dedication to the company
  - Assisting the company in attracting and retaining good employees
  - Providing an avenue for buying out an existing owner when necessary
  - Promoting shared entrepreneurship and lessening the burden on any single entrepreneur
  - Raising and conserving capital by exchanging equity for lower wages
  - Providing valuable tax benefits

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II. How to Motivate Employees

- Companies typically motivate, attract and retain quality employees through a combination of Financial and Non-Financial Compensation programs
- A strategic combination of the two typically produces optimal results for the company and employees alike

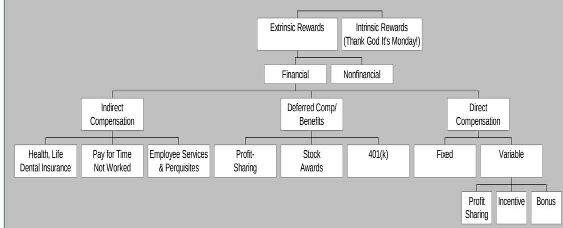
How to Motivate Employees
Financial Compensation

- Base Salary
- Bonuses
  - Discretionary
  - Based upon goals met by the individual or the organization as a whole
- Benefits
  - Health Insurance (employee and dependents)
  - Life Insurance
  - Dental Insurance
  - Flexible Spending Accounts & 401(k) Plans
- Granting an Equity Interest in the Business

How to Motivate Employees
Non-Financial Compensation

- Thank God It's Monday!
- Job Titles
- Leadership Roles
- Flexible Schedules
- Recognition/Attention
- Good Work Environment
- Ask Employees What They Want! (you might be surprised — and easily able to accommodate employees' desires making for a relatively effortless win-win situation)

How to Motivate Employees
Elements of Total Compensation



III. Types of Equity Compensation Instruments

- Equity compensation instruments include:
  - Stock Options
    - Incentive Stock Options (ISOs)
    - Non-Qualified Stock Options (NSOs)
  - Restricted Stock
  - Phantom Stock
  - Stock Appreciation Rights (SARs)

Stock Options
Definition

- Stock options give an employee the right to:
  - Buy (“exercise”) a certain number of shares of the employer’s stock
  - At a specified price (the “award,” “strike” or “exercise” price)
  - Over a certain period of time (the “exercise” period), which is typically ten years or less
- Stock options typically are subject to vesting such that the employee has the right to purchase a certain percentage of shares over period of time – *e.g.*, 25% after two years, 50% after three, 75% after four and 100% after five years

Stock Options
Two Common Types of Plans

- Employee stock options come in two basic flavors:
  - Incentive Stock Options (ISOs)
    ISOs are a class of options created by the IRS and subject to the Internal Revenue Code rules, which, if followed, qualify the options for preferential tax treatment. Hence, they are also known as "Qualified Stock Options."
  - Non-Qualified Stock Options (NSOs)
    NSOs are those options that do not "qualify" or meet the requirements of ISOs. Further, if an employer/employee fails to adhere to the restrictions of an ISO, the stock automatically reverts to non-qualified status.

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Incentive Stock Options (ISOs)
Requirements

- ISOs offer preferential tax treatment. In order to qualify for such tax benefits ISOs *must* meet multiple eligibility requirements including, to name just a few:
  - Must be granted to an employee
  - Under a written ISO Agreement
  - At a price equal to or greater than the "fair market value" at the time of grant (see 409A slides)
  - Via a written Plan specifying the total number of shares that may be issued and the eligible employees
  - The Plan must be approved by the stockholders within 12 months either before or after the plan's adoption
  - Employee must not, at the time of grant, own stock representing more than 10% of the voting power of all stock outstanding
  - The option must be exercised within 10 years of grant
  - The aggregate value of any ISO stock exercised for the first time cannot exceed $100,000 in any given year

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ISOs
Key Provisions

- Employee may buy stock at a specified price which is in compliance with Section 409A (not less than 100% of fair market value) for a given period of time (10-year maximum)
- Options may be exercised in any sequence
- The annual value of ISOs which become exercisable in any one year cannot exceed $100,000 per individual
- Appreciation from grant to sale qualifies for capital gain treatment provided holding period requirements are met (stock must be held at least 2 years after grant and 1 year after exercise)

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ISOs
Tax Consequences for Employee and Employer

- Employee:
  - An employee receiving ISO realizes **no** income upon its receipt (at grant) or exercise
  - The employee is taxed **upon a qualifying disposition** (one held for the holding period) at capital gains rates
  - Disqualifying dispositions are taxed at ordinary income
  - Alternative minimum tax can kick in depending on circumstances
- Employer:
  - Employer is not entitled to a deduction with respect to the issuance of the option or its exercise
  - If the disposition of the stock is qualifying, the employer receives no deduction
  - If the employee causes the option to be disqualifying (by disposing of the stock prior to the end of the holding period), the employer generally may take a deduction for the amount recognized by the employee as ordinary income in the same year as the employee recognizes the income

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ISOs
Summary: Advantages and Disadvantages

- Advantages
  - Employee's tax liability is deferred until stock is sold
  - Long exercise period allows employee flexibility and can be retentive
  - Employee may defer taxes or may sell the stock earlier in a disqualifying disposition
- Disadvantages
  - Employee investment is required at exercise
  - Company loses tax deduction
  - Spread at exercise is considered tax preference item for purposes of computing alternative minimum tax
  - More complicated instrument for administration

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NSOs
Key Characteristics

- All options outside of ISOs, including ISOs that fail to meet the requirements or otherwise qualify as ISOs, are rendered NSOs
  - Employee may buy stock at exercise price for a given period of time so long as the valuation is in compliance with Section 409A of the Internal Revenue Code
  - Appreciation from grant date to exercise date taxed at ordinary income rates
- NSOs differ from ISOs in a number of ways including:
  - They are far more flexible and easier to administer
  - They can be given to anyone – partners, consultants, board members, advisors
  - They are typically taxed at exercise at ordinary income tax rates
  - They provide the employer with an accompanying compensation tax deduction equal to the income recognized by the employee

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NSOs
Tax Consequences for Employee and Employer

- If, as is almost always the case with non-publicly traded companies, the NSOs do not have a readily ascertainable fair market value at the date of grant, there is **no taxable event at the time of grant**
- The tax event occurs at the time the employee **exercises the option**
- The **employee** will be taxed at the ordinary income rates for the amount equal to the difference between the fair market value of the stock at exercise and amount paid for the option
- The **employer** has a corresponding deduction in the same amount at the same time as the ordinary income is recognized by the employee
- If the stock is held after exercise, any additional gain to the employee is generally treated as capital gain

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NSOs
Summary: Advantages and Disadvantages

- Advantages
  - Company receives tax deduction at exercise
  - No limitations on the amount that may be exercised
  - Offers potential for long-term appreciation as company grows
- Disadvantages
  - Employee investment is required
  - Employee incurs tax liability at exercise

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ISOs v. NSOs
Tax Consequences

- The preferential tax treatment available via ISOs include:
  - ISOs are taxed when the employee sells the stock (not at the time of grant or exercise) while NSOs are taxed on the date of exercise
  - Therefore, with ISOs, paying taxes on unsold but exercised option stock is avoided (which potentially could become worthless) and profit is not realized unless and until the stock is sold
- ISO shares may receive long-term capital gain tax treatment
  - If the holding period is met – *i.e.*, the later of 1 year after the stock is transferred to the employee or 2 years after the option is granted – the ISO stock is taxed at the lower long-term capital gains rate, which is currently 15(20)%
  - NSOs are taxed at ordinary income rate which can go up to 39.6%
- Note: Alternative Minimum Tax requirements may apply in certain situations, thereby reducing the tax benefits of ISOs

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ISOs v. NSOs
Tax Implication Comparison Chart

	ISO	NSO
Employee exercises option	No tax	Ordinary income tax (up to 39.6%)
Employer gets tax deduction?	No deduction	Tax deduction upon employee exercise
Employee sells options after holding period	Long-term capital gains tax at 15(20)%	Long-term capital gains tax at 15(20)%

1000 shares @ $10 exercise price 20% capital gain tax	ISO	NSO
Employee exercises when market value is $20/share and 28% tax bracket	No tax paid	Tax = ($20 – $10) * 1,000 * (0.28) = $2,800
Employee sells at $30/share after holding period	($30 – $10) * 1,000 * (0.20) = $4,000	($30 – $20) * 1,000 * (0.20) = $ 2,000
Total tax paid	$4,000	$4,800

Restricted Stock
Definition

- Restricted stock refers to stock in a company with limitations attached, such as:
  - Requirement that a certain amount of time passes
  - Certain goals be achieved prior the stock being transferrable
  - Subject to forfeiture if employment is terminated
- Upon satisfaction of the conditions, the stock vests and becomes transferable

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Restricted Stock
Key Provisions

- Outright grant of shares with restrictions as to sale, transfer and pledging
- Restrictions lapse over a period of time (*e.g.*, three to five years)
- As restrictions lapse, employee has unrestricted shares which he may sell, transfer or pledge (subject to limitations in corporate documents such as stockholders' agreement)
- If employee terminates employment, all unvested shares are forfeited
- During restriction period, employee receives dividends and can vote the shares

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Restricted Stock
Tax Consequences for Employee and Employer

- Tax Impact on Employee (absent 83(b) election)
  - At grant – no tax
  - As restrictions lapse – the current market value of vested shares taxed as ordinary income
  - Dividends received during restriction period taxed as ordinary income
- Tax Impact on Company (absent 83(b) election)
  - At grant – no tax deduction
  - As restrictions lapse – company receives tax deduction equal to employee's ordinary income
  - At sale – no tax deduction
  - Dividends paid during restriction period are deductible by company when paid

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Restricted Stock
Summary: Advantages and Disadvantages

- Advantages
  - No employee investment required
  - Promotes immediate stock ownership
  - Recognizable to most employees
  - Offers employee potentially long-term appreciation as company grows
- Disadvantages
  - Immediate dilution of EPS
  - Employee may incur tax liability before shares are sold

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Restricted Stock
83(b) Election

- Advantages
  - Allows employees to pay tax at the time of receipt of stock at the then current fair market value (FMV) and thereby lock in the low value of the stock
  - Capital gain holding period begins at grant and not at vesting
- Disadvantages
  - Accelerated payment of taxes (must be filed within 30 days of receipt of the stock)
  - Overpayment of taxes in case the value of the stock decreases
  - If the FMV is set high due to venture capital funding, substantial income tax may be paid on stock which may or may not be valuable
  - If the stock is forfeited, there is no loss deduction

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Phantom Stock

- Phantom Stock refers to a type of incentive grant in which:
  - A promise to pay a bonus based on some formula or allocation
  - Recipient is not issued actual shares of stock on the grant date, but rather receives "hypothetical" stock (the company gives the employee the benefits of owning stock in the company without actually granting stock)
  - Phantom stock increases or decreases in price and pays "dividends" as if it were real
  - Eventually, the phantom stock is settled and cash is distributed to the employee
  - Phantom stock distributions are not "qualified" and are taxed as ordinary income at distribution

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Stock Appreciation Rights (SARs)

- A Stock Appreciation Rights ("SARs")
  - Contractual arrangement between a company and an individual, usually an employee
  - The recipient has the right to receive an amount equal to the appreciation on a specified number of shares of stock
  - Over a specified period of time
  - Normally paid out in cash, but it could be paid in shares
- Generally, a recipient's ability to exercise a SAR is subject to a contractual "vesting" provision that expires after a specified period of time, either all at once or in increments
- May be granted in conjunction with options – to pay for their purchase at exercise

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How SARs Differ from Stock Options

- SARs differ from stock options in the following ways:
  - Recipient is not required to pay an amount to exercise the SARs
  - Recipient only receives the appreciation in the value of the stock between the date of grant of the SAR and the date of exercise (generally, the recipient controls the timing of exercise)
  - Recipient generally does not receive any shares of stock of the granting company (the amount received by the recipient is payable in cash)

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Phantom Stock and SARS
Tax Consequences for Employee and Employer

- Employees are taxed when the right to the benefit is exercised
- At that point, the value of the award, minus any consideration paid for it (there usually is none) is taxed as ordinary income to the employee and is deductible by the employer
- If the award is settled in shares (as might occur with an SAR), the amount of the gain is taxable at exercise, even if the shares are not sold
- Any subsequent gain on the shares is taxable as capital gain

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Special Considerations in S Corporations and LLCs
General

- S Corporation
  - Limit of 100 shareholders
  - None of the shareholders may be a nonresident alien
  - Treated as corporate entities and ISOs are available
  - Upon filing of 83(b)/exercise of options the holder is considered a stockholder
  - Phantom stock and SARs are a possibility if they don't create a second class of stock
- LLC
  - High administrative cost and complexity in pass through LLCs
  - ISOs are not available except where LLC has elected to be taxed as a C corporation
  - Value of unrestricted capital interests granted (less anything paid) is ordinary income and deduction is available to company
  - Restricted capital interest is taxed at time of vesting and deduction is available
  - 83(b) election is available

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VI. The Importance of Fair Market Value
Section 409A of the Internal Revenue Code

- Congress enacted Section 409A of the Internal Revenue Code as part of the American Jobs Creation Act of 2004 in response to perceived abusive compensation practices
- Section 409A applies to non-qualified deferred compensation (NQDC) plans
- Deferred compensation plans which do not meet the specific requirements of 409A are treated as "current income" and subject to a significant excise taxes plus penalties
- Section 409A of the Internal Revenue Code applies to employees, directors and "other service providers"
- Section 409A contains very specific rules governing the timing of deferrals, timing of distribution, funding methods and various other aspects of deferred compensation

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409A Penalties for Non-Compliance

- If there is a violation, affected service providers owe:
  - Current tax on deferrals for current year and all prior years (to the extent not subject to a substantial risk of forfeiture)
  - Interest at underpayment rate +1% from original deferral date
  - Additional tax of 20% of the taxable compensation
- If the plan is not drafted correctly, all plan participants could be "affected" and all post-2004 deferrals taxable

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Exceptions to 409A Coverage

- Section 409A defines deferred compensation broadly to include elective deferred compensation plans as well as non-elective arrangements
- Exceptions to Section 409A coverage include the following equity compensation instruments:
  - Non-discounted stock options
  - Restricted Stock
  - Stock Appreciation Rights (SARs)
- In order to fall into the 409A exception, however, the equity compensation instrument MUST be valued at "fair market value" *at the time of grant*

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How Does 409A Affect Stock Options and SARs?

- Non-discounted options are not subject to Section 409A
- Similar treatment now extends to all SARs
  - Private and public companies
  - Cash and stock settled arrangements
- Exercise price may not be less than the "value" of the "service recipient stock" on the "grant date"
- Tax on vesting for discounted stock options & SARs
- Concepts apply to LLCs and partnerships

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How is Value for a Private Company Determined under 409A?

- Value is determined "by the reasonable application of a *reasonable* valuation method" – what does that mean?
- Unreasonable to use:
  - Previously calculated value that fails to reflect all material information
  - Calculation that is more than 12 months old
- Two primary safe harbors:
  - Written valuation report for illiquid stock by a person with significant knowledge and experience
  - Independent Appraisal (which can cost a cash strapped start-up $5,000 to $7,000)

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IRS Guidelines for 409A Valuations

- "Reasonable method, reasonably and consistently applied"
  - The value of tangible and intangible assets
  - The present value of future cash-flows
  - The market value of stock or equity interests in similar companies and other entities engaged in businesses substantially similar to those engaged by the corporation
  - Recent arm's length transactions involving the sale or transfer of the stock
  - Other relevant factors, such as control premiums or lack of marketability

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VI. Which Plan is Right for Your Company?

- Administrative complexity (ISOs and LLCs)
- Tax consequences for service providers and employers
- Size of compensation pool
- Pre-IPO considerations
- Vesting patterns
- Paying for the stock
- Signing the stockholders agreement at exercise
- Repurchase rights

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Incentive Stock Options
Sample Calculations – 1

Assumes the capital gain rate is 15%

Incentive Stock Option	Grant	Exercise	Sale	
Fair Market Value:	$2	$6	$9	
Employee Investment:	$0	$2		
Employee Gain:	$0	$0	$7	(Capital Gain)
Employee Tax:	$0	$0	$1.05 ($7x.15)	Tax Due
Employee Net Gain: (After Tax)	$0		$5.95	Net Gain

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Incentive Stock Options
Sample Calculations – 2

Assumes the capital gain rate is 15%

Incentive Stock Option	Grant	Exercise	Sale	
Fair Market Value:	$5	$10	$12	
Employee Investment:	$0	$5		
Employee Gain:	$0	$0	$7	(Capital Gain)
Employee Tax:	$0	$0	$1.05 ($7x.15)	Tax Due
Employee Net Gain: (After Tax)	$0		$5.95	Net Gain

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Non-Qualified Stock Options
Sample Calculations – 1

Assumes the capital gain rate is 15% and ordinary income tax rate is 35%

Non-Qualifed Stock Option	Grant	Exercise	Sale		
Fair Market Value:	$2	$6	$9		
Employee Investment:	$0	$2			
Employee Gain:	$0	$4	$3		Total Gain
		Ordinary Income	Capital Gain		$7.00
Employee Tax:	$0				Total Tax Due
		($4x.35 = $1.40)	($3.00 x.15 = .45)		$1.85
Employee Net Gain:	$0			Total Net Gain	
(After Tax)		$2.60	$2.55	$5.15	

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Non-Qualified Stock Options
Sample Calculations – 2

Assumes the capital gain rate is 15% and ordinary income tax rate is 35%

Non-Qualified Stock Option	Grant	Exercise	Sale	
Fair Market Value:	$5	$10	$12	
Employee Investment:	$0	$5		
Employee Gain:	$0	$5	$2	Total Gain
		Ordinary Income	Capital Gain	$7.00
Employee Tax:	$0			Total Tax Due
		($5 x.35 = $1.75)	($2 x.15 =.30)	$2.38
Employee Net Gain:	$0			Total Net Gain
(After Tax)		$3.25	$1.70	$4.95

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Restricted Stock
Sample Calculations – 1

This example assumes the employee is subject to an ordinary income tax rate of 35%. If an 83(b) election were made within 30 days of the award, the employee would be taxed on the fair value of the stock at grant as ordinary income, with subsequent appreciation treated as a capital gain. 83(b) elections are sometimes not made because the employee cannot recover taxes paid at grant if he or she forfeits the shares if the shares decrease in value.

Restricted Stock	Grant	Restrictions Lapse	
Fair Market Value:	$2	$10	
Dividends	$0	$1.00	
Employee Investment:	$0	$0	
Employee Gain:	$0	$11	(Ordinary Income)
Employee Tax:	$0	$3.85	Tax Due
		($11.00x.35)	
Employee Net Gain: (After Tax)	$0	$7.15	Net Gain

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Restricted Stock
Sample Calculations – 2

This example assumes the employee is subject to an ordinary income tax rate of 35%. If an 83(b) election were made within 30 days of the award, the employee would be taxed on the fair value of the stock at grant as ordinary income, with subsequent appreciation treated as a capital gain. 83(b) elections are sometimes not made because the employee cannot recover taxes paid at grant if he or she forfeits the shares if the shares decrease in value.

Restricted Stock	Grant	Restrictions Lapse	
Fair Market Value:	$5	$10	
Dividends	$0	$1.00	
Employee Investment:	$0	$0	
Employee Gain:	$0	$11	(Ordinary Income)
Employee Tax:	$0	$3.85	Tax Due
		($11.00x.35)	
Employee Net Gain: (After Tax)	$0	$7.15	Net Gain

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