Equity Compensation: When Does It Make Sense and What Types of Awards Should You Use?

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Presenter

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Agenda

Equity compensation basics

Taxation of common types of equity compensation for corporations

Special considerations for equity compensation for partnerships

Equity Compensation Basics

What is Equity Compensation?

- “Equity compensation” means compensation payable by an employer (or other “service recipient”) to an employee (or other eligible “service provider”) measured by the value of the service recipient’s equity (e.g., shares of stock, partnership interests, etc.)
- May be payable in actual shares (“share-settled”) or cash of equivalent value (“cash-settled” or “phantom equity”)
- Typically documented through the combination of (i) an equity compensation plan and (ii) individual award agreements

What Business Purposes Can Equity Compensation Serve?

Goals in common with cash-based incentives

- Retention
- Performance incentives
- Consideration for post-employment covenants

Goals uniquely served by equity compensation

- Alignment of interest with shareholders
- Conservation of cash

"The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own."

Adam Smith, The Wealth of Nations (1776)

Key Considerations
(In Addition To Tax Treatment)

Securities laws

- ’33 Act (and state blue sky laws) – registration of plan or exemption from registration
- '34 Act – for public companies, proxy statement disclosures, Section 16 reporting, insider trading, etc.

Governance

- State corporate laws, including board authority to make awards, delegation of authority, business judgment rule, etc.
- For public companies, listing rules for stock exchanges, including shareholder approval of equity compensation plans

Accounting – fixed v. variable (mark-to-market)

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Taxation of Common Types of Equity Compensation for Corporations

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Appreciation Rights
v.
Full Value Awards

Can break down equity compensation into two broad categories of awards:

- – including stock options and stock appreciation rights (SARs)
- – including restricted stock awards (RSAs) and restricted stock units (RSUs)

Appreciation Rights v. Full Value Awards: Economic Pros/Cons

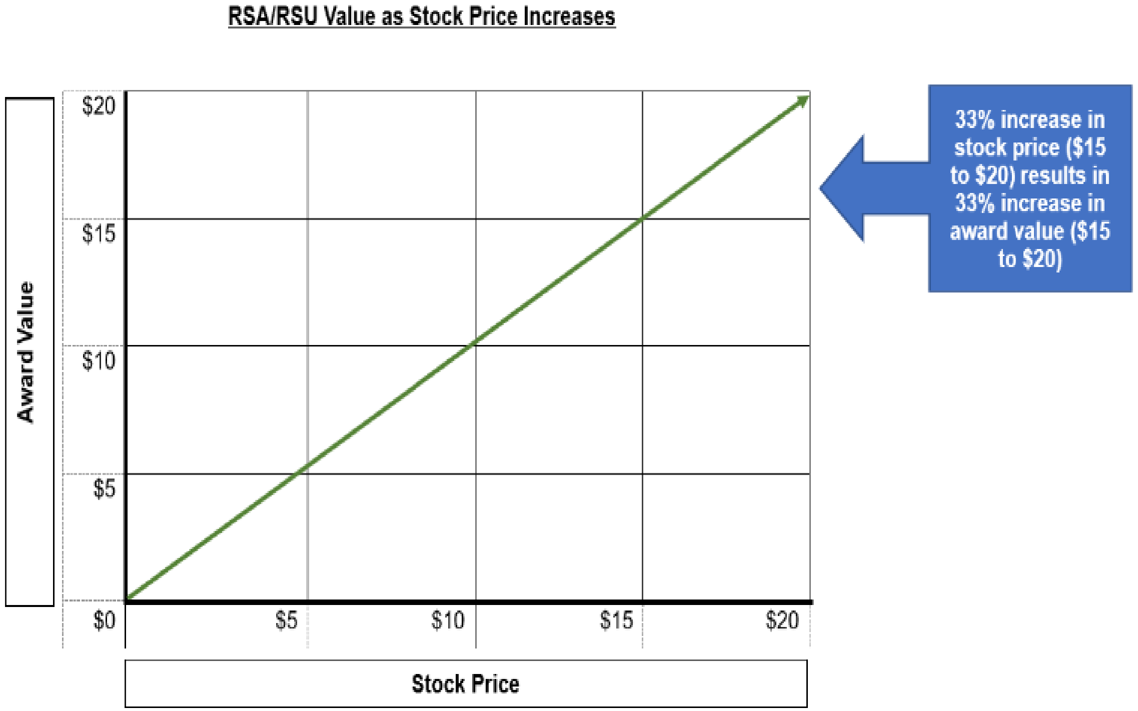
Appreciation Rights – Economic Pros

- Super-charged incentive to grow equity value – positive leverage

Appreciation Rights – Economic Cons

- Underwater awards can be demotivating while still generating accounting costs

Appreciation Rights v. Full Value Awards: Economic Pros/Cons



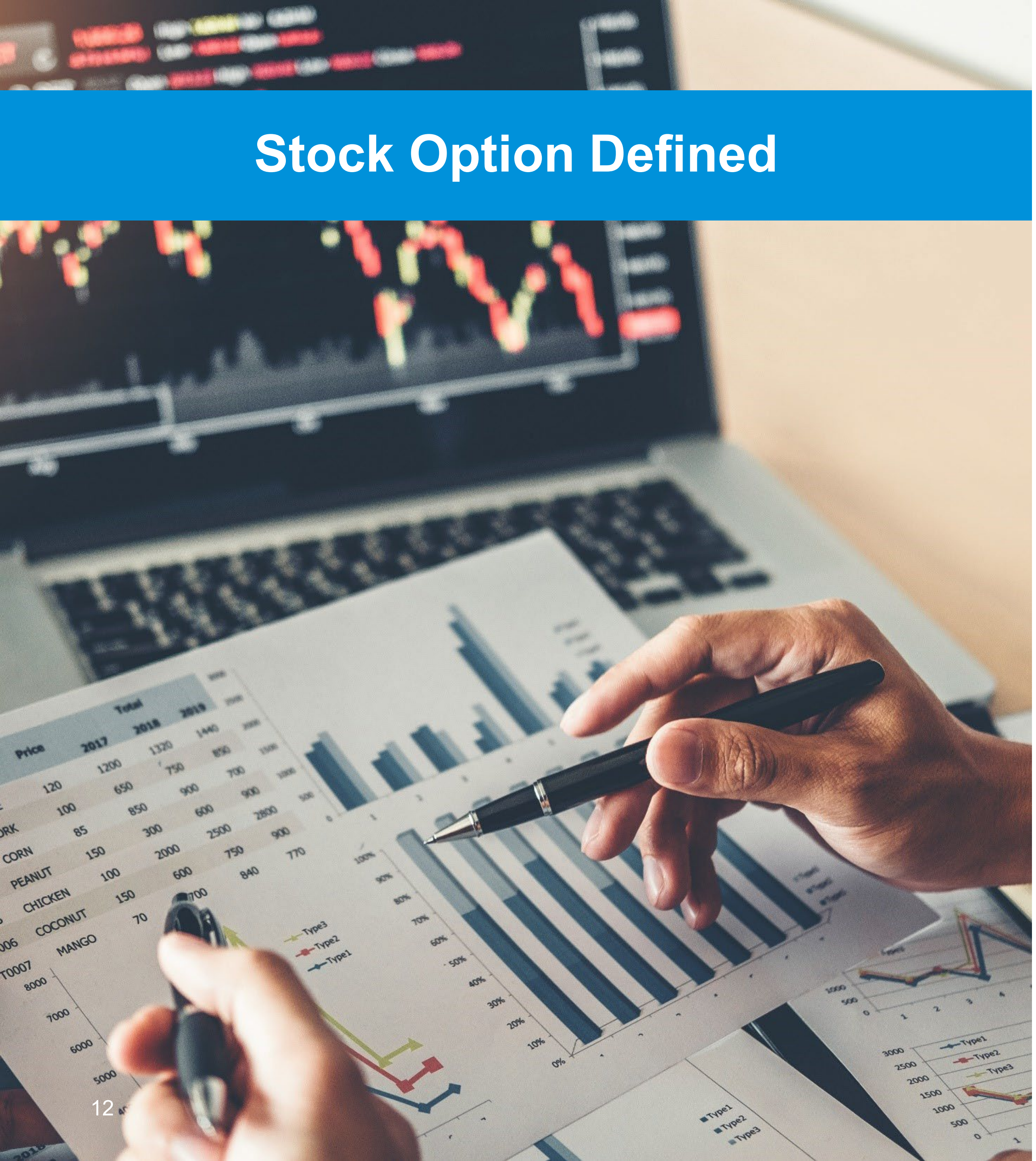
Full Value Awards – Economic Pros

- Retention incentive – retains value through down cycles

Full Value Awards – Economic Cons

- Less upside incentive than appreciation rights

Stock Option Defined



Definition: A contractual right to purchase a fixed number of underlying shares at a fixed price for a fixed period of time.

Key types for tax purposes:

- Nonqualified stock options (NQSOs)
- Incentive stock options (ISOs)

Common methods to pay the exercise price (in addition to cash/check)

- <u>Stock swap exercise</u>: Deliver (or attest to ownership) of previously acquired shares to cover cost of exercise
- <u>Net exercise</u>: Surrender right to receive a portion of the underlying option shares to cover cost of exercise (economically same as share-settled SAR)
- <u>Broker-assisted cashless exercise</u>: For public companies only; broker immediately sells shares to cover exercise price (form of margin loan)

SAR Defined

- A contractual right upon exercise to receive the appreciation in value of a fixed number of underlying shares over a beginning base value
- Appreciation realized at exercise may be paid in shares (a “share-settled” SAR) or cash (a “cash-settled” SAR)

RSAs and RSUs Defined

An RSA represents the issuance of shares of stock to the service provider at grant, but with both restrictions on transfers and vesting conditions that could result in an obligation of the service provider to return the shares

- Typically includes voting rights during vesting period
- Cash dividends typically either paid immediately or accrued and paid if the award vests

An RSU represents a contractual right of the service provider to be issued a share at a future date if vesting conditions are met

- No voting rights
- May include "dividend equivalents" that replicate cash dividends on actual shares

Key IRC Sections for Equity Compensation

Section 409A

- Applies to "nonqualified deferred compensation plans," which is broadly defined and could include certain types of equity awards
- Key exceptions for certain stock options/SARs (stock rights exemption), "short-term deferrals," and RSAs
- If 409A is applicable and the award fails to comply, can have significant adverse tax consequences mainly for the service provider, including accelerated income recognition and a 20% additional tax

Section 83

- Applies to transfers of property in exchange for services, including RSAs and (at time of exercise) NQSOs
- Taxation occurs generally when either the property is transferable or no longer subject to a "substantial risk of forfeiture," but can be at time of grant if an 83(b) election is made

Key IRC Sections for Equity Compensation

Section 3121

- For employees, income on equity compensation awards is also wages for FICA taxes (social security and Medicare)
- “Special timing rule” for nonqualified deferred compensation can apply to some equity awards under Section 3121(v)

Sections 422 and 423 (favorable tax treatment)

- ISOs and employee stock purchase plans (ESPPs) can provide favorable tax treatment to employees if awards meet the requirements of Sections 422 and 423
- More on ISOs later in the presentation, but we will not further address ESPPs

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Variables to Consider When Picking Equity Award Vehicles

- Flexibility for service provider to determine timing of taxation
- Ordinary income v. capital gains tax treatment
- Liquidity needs of service provider (e.g., to pay exercise price or cover required tax withholding)

Key Moments in the Life-Cycle of Equity Awards

Grant Date: The date that all material terms of the award have been duly approved

Vesting Date: The date that any “substantial risk of forfeiture” lapses

Exercise Date: For options/SARs, the date that the service provider takes all required action to cause the award to be exercised, including delivery of any exercise notice and (for options) payment of the exercise price

Settlement Date: For RSUs, the date that shares are issued (or equivalent cash is paid), which could be the same as the vesting date or a later specified date

Sale Date: For share-settled awards, the date that the service provider sells shares previously received from the award.

Taxation of Appreciation Rights

Summary

NQSOs:

- Service Provider: Ordinary income at exercise equal to spread
- Service Recipient: Tax deduction at same time

ISOs:

- Service Provider (Employee): Three key benefits: (i) no tax at exercise, only at time of sale of shares; (ii) no FICA taxes; and (iii) if hold shares at least two years from grant and one year from exercise, all gain on sale is long-term capital gain
- Service Recipient: No tax deduction, unless income recognized on a disqualifying disposition by the employee

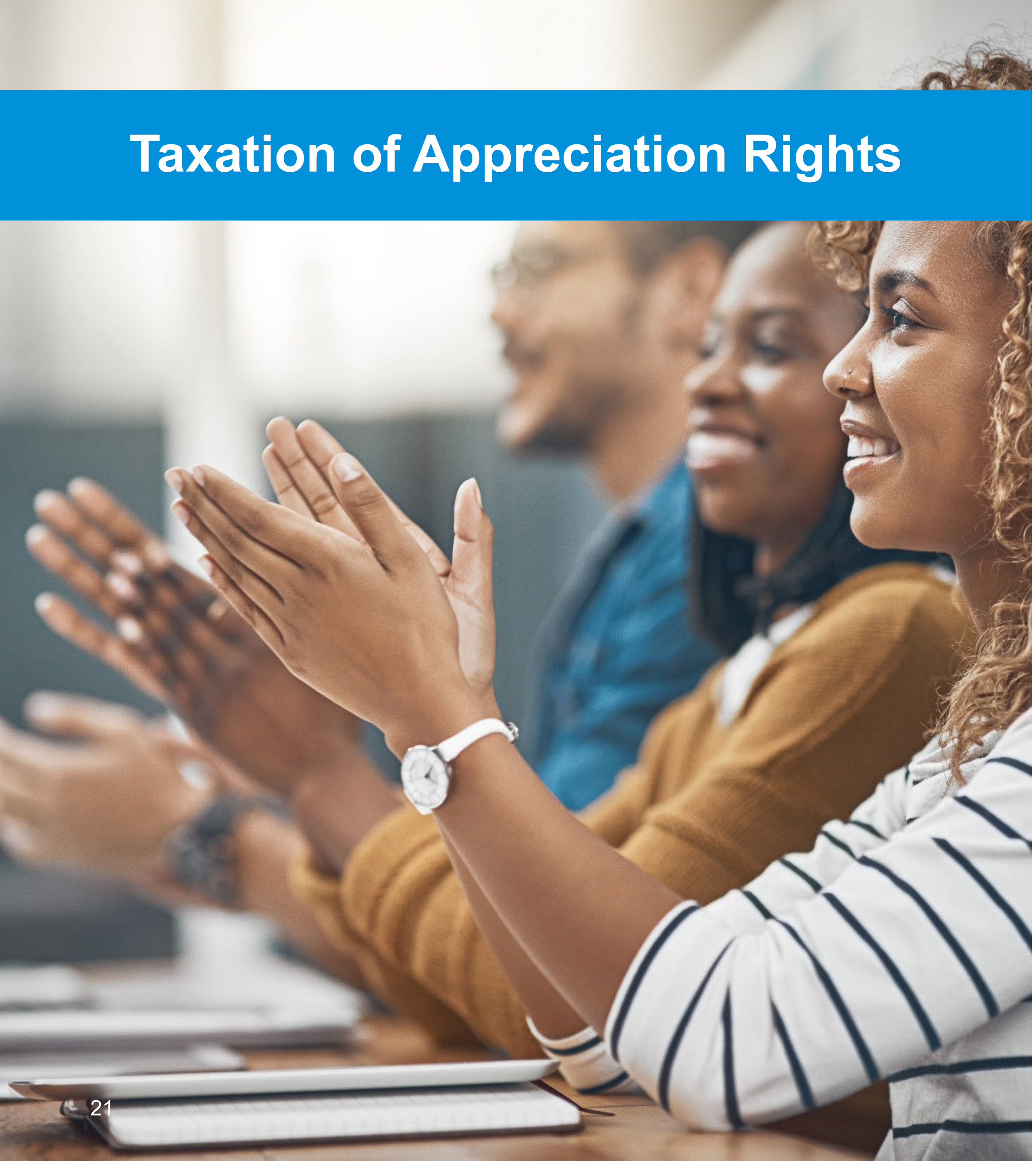
SARs – same as NQSOs

Taxation of Appreciation Rights: Example

Assumptions: Award for 100 underlying shares; Exercise Price = $30/share

Event	ISOs	NQSOs	SARs
Grant **$30/share**	No tax	No tax	No tax
Vesting	No tax	No tax	No tax
Exercise **$50/share**	100 shares issued No ordinary income* No corporate deduction	100 shares issued Ordinary income = $2,000 100 x ($50-$30) Corporate deduction = $2,000	40 shares issued Ordinary income = $2,000 100 x ($50-$30) Corporate deduction = $2,000
Sale of Shares **$75/share**	<u>If shares held for required period</u>: Capital gain = $4,500 100 x ($75-$30) No corporate deduction <u>If a disqualifying disposition</u>: Ordinary income = $2,000 Capital gain = $2,500 Corporate deduction = $2,000	Capital gain = $2,500 100 x ($75-$50)	Capital gain = $1,000 40 x ($75-$50)

*Note: The spread value at exercise of the ISO is taken into account when calculating the alternative minimum tax.



Taxation of Appreciation Rights

Tax Traps for the Unwary

- Granting in-the-money options/SARs
- Extending the exercise period for options/SARs beyond the original expiration date
- Granting options/SARs with respect to preferred stock
- Providing dividend equivalents on options/SARs
- Granting options/SARs on a brother/sister affiliated company
- Poor grant practices

Taxation of Full Value Awards: Summary

RSAs

- Service Provider: Ordinary income when substantial risk of forfeiture lapses, unless an 83(b) election is made at grant, in which case ordinary income at grant, in each case based on FMV of the shares on the applicable date
- Service Recipient: Tax deduction at same time

RSUs

- Service Provider: Ordinary income based on FMV of underlying shares at the time the service recipient “initiates payment”; no 83(b) election allowed
- Service Recipient: Tax deduction at same time

Taxation of Full Value Awards: Example

Assumptions: Award for 100 underlying shares.

Event	RSAs 83(b) Election	RSAs No 83(b) Election	RSUs Settlement at Vesting	RSUs Settlement after Vesting
Grant $30/share	Ord. income = $3,000 100 x $30 Corp. deduction = $3,000	No tax	No tax	No tax
Vesting $50/share	No tax	Ord. income = $5,000 100 x $50 Corp. deduction = $5,000	Ord. income = $5,000 100 x $50 Corp. deduction = $5,000	No tax*
Settlement $60/share	N/A	N/A	N/A	Ord. income = $6,000 100 x $60 Corp. deduction = $6,000
Sale of Shares $75/share	Capital gain = $4,500 100 x ($75 - $30)	Capital gain = $2,500 100 x ($75 - $50)	Capital gain = $2,500 100 x ($75 - $50)	Capital gain = $1,500 100 x ($75 - $60)

*FICA withholding may apply under section 3121(v) special timing rule.

Taxation of Full Value Awards: Tax Traps for the Unwary

- Retirement vesting for RSAs, potential lapse of substantial risk of forfeiture upon retirement eligibility
- Retirement/good leaver vesting for RSUs, Section 409A compliance
- Section 409A "Toggle Rule" for RSUs, especially for settlement triggered by disability

When to Consider Appreciation Rights v. Full Value Awards

Appreciations Rights might be best if:

- Service provider control over timing of tax is important
- Trying to highly motivate stock price growth
- Want to match company liquidity event (sale or IPO) with liquidity needs for award (e.g., exercise at liquidity event)
- Okay with ordinary income rather than capital gains (can use ISOs within limits to partially address)

Full Value Awards might be best if:

- This is an early-stage company with low-value shares and high growth potential, in which case you can grant RSAs with an 83(b) election
- Want to encourage retention even through possible adverse economic cycles
- Want to add performance incentives apart from stock price growth (such as with performance share units)

Tax Withholding Requirements

For employees, ordinary income from equity awards is subject to tax withholding requirements for supplemental wages

Mandatory withholding at top marginal rate (37%) for aggregate supplemental wages over $1M in a year

For supplemental wages under $1M, can use either:

Aggregate Method: Based on employee's W-4 elections, treated like base wages	*Optional Flat Rate*: If employee has received base wages in current or prior year, can withhold at 22%

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Tax Withholding Common Techniques

<u>Employee Check</u>: Employee provides cash (either from other cash wages or by paying the service recipient directly)

- Requires employee liquidity

<u>Share Withholding</u>: Shares from the award are withheld equal in value to the withholding obligation

- Solves employee liquidity problem but reduces service recipient cash reserves

<u>Sell-to-Cover</u>: For public companies, the service provider's broker sells on the market enough shares at the time of tax to cover the withholding obligation

- Solves the employee liquidity problem and does not reduce company cash reserves, but need to comply with insider trading policies and will be a matchable transaction under Section 16 (if applicable)
- For public companies, need to complete in time to meet T+2 requirements (per 2020 IRS memo after the 2024 change to T+1 from T+2)

Special Considerations For Equity Compensation For Partnerships

Differences from Corporations

- Significant contractual flexibility to create the relative economic rights of owners
- Ownership not typically in units (like shares), but in percentage interests
- Different tax regime given pass-through nature – not always clear how equity compensation works by analogy to corporations

Appreciation Rights in Partnerships

Potentially can have options and SARs

- For purposes of Section 409A, IRS has said can apply corporate rules by analogy
- Likely requires ownership interests to be expressed in units (analogous to shares of common stock)

More commonly, awards are made as "profits interests"

- Represents an actual ownership interest but with no right to share in value of the partnership at date of grant if partnership was then liquidated at its FMV
- Per IRS Revenue Procedures 93-27 and 2001-43, if the award is not disposed of for at least two years, and the grantee is treated as a partner from the date of issuance, neither the grant date nor the vesting date will be a taxable even
- If appreciation in value results from a capital transaction, all realized gains may be taxed as capital gains rather than ordinary income

Full Value Awards in Partnerships

- Restricted capital interests – analogous to RSAs
- Capital interest restricted units – analogous to RSUs

“Phantom Equity” Cash Awards

- Receipt of profits interests or capital interests can convert W-2 employees into K-1 partners, which can have adverse impacts on employees such as (i) loss of favorable benefits (like cafeteria plans) and (ii) requirement to pay self-employment taxes
- Can also create information or governance rights in the partnership
- To avoid these outcomes, cash-settled awards measured by the value of partnership ownership interests can be used – i.e., a form of “”
- Care needs to be taken in the design to ensure the awards are either (i) exempt from Section 409A, or (ii) if not exempt, compliant with Section 409A
- Income from phantom equity will be taxed as ordinary income and subject to withholding for employees

Preserving W-2 Status of Award Recipients

- If preserving W-2 status is important, can also consider a “tiered partnership structure”
- Allows for use of profits interests or capital interests (rather than phantom equity) through a “management aggregator” entity
- The operating partnership awards profits interests or capital interests to the management aggregator which then grants interests in the management aggregator to the service providers that mirror the operating partnership interests – i.e., a “back-to-back” award structure

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Conclusion

- Properly designed equity compensation awards can drive business success
- Equity of the company, however, is a limited, precious resource, and therefore care needs to be taken when determining whether to use equity compensation, and if so, the types of awards to use
- Decisions need to be made to align the business purposes to be served with the tax treatment, liquidity needs, and other varying features of alternative equity award vehicles
- One size definitely does not fit all

Questions?

Thank You

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