Equity Incentive Plans: Compensating Key Employees with Equity, Options and Equity Appreciation Awards

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Introduction

There comes a point in the life cycle of many businesses when its employees desire equity in consideration of their services to the business—the employees want to become owners and not just work for the business and its owners. Wanting to align the interests of the employees with those of the business, the business owners may be receptive. What the business owners do not want, however, is to give up control of the business or adopt a system that is burdened with legal and tax complexities.

This article will discuss the factors that businesses, particularly those that are closely held, should consider when developing an equity incentive plan while giving a basic explanation of the key legal and tax concepts involved.

Factors

Characteristics of Equity, Options and Equity Appreciation Awards

The first issue that business owners should consider is whether they are willing to provide the employee with (i) a present equity interest in the company, (ii) an option to acquire an equity interest in the company at a future date, or (iii) an equity appreciation award, consisting of a contractual right to receive a future payment in the event the company subsequently appreciates in value, but otherwise provides no equity holder rights.

Equity ownership of a company gives the equity holder certain legal rights. While such rights differ by state, they typically include the right to inspect the corporate records and possibly the right to receive the financial statements of the company. Equity holders also have the right to vote on so-called fundamental transactions, such as mergers, acquisitions, a sale of the company and the right to approve an amendment to its articles of incorporation or bylaws. This bundle of rights is typically referred to as "statutory rights." Further, equity ownership will typically grant the equity holder a vote in all other equity holder level decisions, such as the right to elect the board of managers or board of directors of the company. These rights are typically referred to as "non-statutory rights." While an equity holder cannot generally waive his or her statutory rights, with careful planning, the company can adopt an equity incentive plan which does not grant the employee any non-statutory rights. This is done by issuing "non-voting" equity to employees under the equity incentive plan.

An option, on the other hand, provides its holder the right to purchase a certain amount of equity of the company at a fixed price (the "strike price") at some point in the future. An option may be favored by the company because it does not grant the holder with any statutory or non-statutory rights, at least not until the option is exercised and the option holder becomes an equity holder. Further, unless the company's equity appreciates to a level that exceeds the strike price before the option expires, the holder will have no immediate financial incentive to exercise the option. Thus, the option may never be exercised.

Similarly, equity appreciation awards (sometimes referred to as "phantom equity" awards) give the holder the right to receive payment in the future equal to the difference between the value of the equity as of the date of grant and the value of the equity as of the date the award is paid. Much like options, an equity appreciation award will never yield value to its holder unless there is equity appreciation. Unlike options, however, the employee will never receive equity in the company as a result of an equity appreciation award.

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Employee Tax Considerations

The employee's federal income tax considerations are typically a major factor in determining whether the employee requests equity, options or an equity appreciation award.

When an employer grants an employee with equity that is fully earned or "vested" on the date granted, the employee is treated as if he or she received an amount of compensation from the employer equal to the fair market value of the equity as of the date of grant. Because equity in a closely held business is illiquid and often subject to transfer restrictions, the employee is often left with a tax bill with no cash on hand to discharge the tax liability. There are strategies available to mitigate the harsh tax affects of this.

First, the employer can subject the equity grant to a "substantial risk of forfeiture." Equity is subject to a substantial risk of forfeiture if the equity will be forfeited in the event that the employee's employment ends prior to the end of the vesting period (typically two to four years). Once this restriction lapses, the equity will be deemed earned ("vested") and the employee will incur a tax liability. Vesting provisions can be prorated over time so the employee does not incur the entire tax liability at once. This would entail allowing the employee to earn a portion for each month or quarter over which the employee's employment period extends. This type of vesting allows the employee to pay tax on the award over a period of two or more years rather than being taxed on the full amount in the year of the grant.

Second, if immediately vested equity is granted, the employer can satisfy the employee's federal income tax obligation by withholding a sufficient amount of the equity. For example, if the employer intends to grant the employee 10,000 vested shares valued at $1.00 per share, the employee would be taxed as if he or she was paid $10,000 in cash compensation as of the date of grant. If the employee is in the 35% tax bracket, the employee would be subject to a $3,500 federal income tax liability. However, the employer may withhold 3,500 shares and satisfy the federal income tax liability on behalf of the employee (thus the employee would receive only 6,500 shares, but would essentially have no further federal income tax obligation).

If the employee receives options, the employee generally will not realize an immediate income tax liability as of the date of grant provided that the strike price of the option is at or above fair market value as of that date. Once the employee exercises the option, however, the employee will likely realize ordinary income equal to the difference between the strike price of the option and the fair market value of the equity as of the date of exercise. If the equity received upon exercise of the option is subject to a substantial risk of forfeiture though, the employee is not required to recognize any taxable income until the equity is vested.

Regardless of whether equity is obtained through a direct equity grant, a vesting schedule or the exercise of an option, the gain resulting from such grant or exercise is treated as "ordinary income" for federal income tax purposes. When and if the employee subsequently disposes of the equity, however, any appreciation occurring after the date the equity was vested will be treated as "capital gain" for federal income tax purposes. As of the date of this article, the highest ordinary income tax rate is 35%, while the typical long-term capital gains tax rate is 15%.

This rate differential gives rise to a unique tax planning opportunity commonly known as a "Section 83(b) election" (named after the section of the federal tax code within which it is found). As discussed above, employees will generally not recognize a tax liability until their equity is vested. If an employee makes a Section 83(b) election, however, ordinary income is accelerated and the employee voluntarily pays tax presently as if he or she earned the full amount of equity as of the date of the election. This essentially cuts-off any further ordinary income tax liability and allows future gains to be treated as capital gains. Thus, if the employee anticipates that the company will quickly appreciate in value, the employee will want to recognize any income tax liability as soon as possible in order to convert any future appreciation into capital gain as opposed to ordinary income. If exercised, the Section 83(b) election creates risk that the equity does not appreciate, in which case the person who exercised the election will have paid taxes sooner than would have otherwise been required. Further, if the person leaves the employ of the company before vesting occurs, the payment of taxes under Section 83(b) will prove to have been unnecessary altogether.

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Finally, if an employee receives an equity appreciation award, the employee will generally not realize any immediate tax liability but will realize ordinary income when the award is actually paid.

Employer Tax Considerations

While a vesting schedule will generally allow an employee to defer tax liability until the equity is vested, it will also delay the employer's ability to deduct that amount as compensation paid. Conversely, a Section 83(b) election causes an acceleration of both the employee's payment of taxes and the employer's deduction of the compensation expense. While the timing of the employer's tax deduction is generally not a predominant factor in structuring equity incentive plans (instead, the employee's tax considerations are typically a driving force), it is a factor that should nonetheless be considered.

Golden Handcuffs

Not only will a vesting schedule allow employees to defer tax liability until the equity is vested, such provisions also entice employees to continue their employment with the employer. The employer can use a vesting schedule to condition vesting upon on any number of factors, including certain performance criteria or simply the continued employment with the employer. If the employee fails to meet the specified performance criteria or terminates his or her employment, the employee's "unvested" equity will be forfeited. This is known as a golden handcuff provision because the employee is essentially "handcuffed" to the employer until the vesting provisions expire and the employee can reap the economic benefits of the equity grant.

Buy/Sell Agreement

Finally, prior to forming an equity incentive plan, an employer would typically want to have a buy/sell agreement in place which provides for the redemption of the employee's equity once the employee/employer relationship is terminated. For example, once an employee is terminated for poor performance, the employer would probably not want that employee to maintain his or her equity interest in the company. Redemption provisions allowing for the employer to redeem all shares held by a departing employee are typically found in a buy/sell agreement, sometimes known as a shareholders agreement, operating agreement or limited partnership agreement, depending on the type of entity involved. A condition precedent to an equity or option grant should be that the employee execute whatever form of buy/sell agreement is in place prior to receiving equity. This will ensure that the employee can be divested of his or her equity upon terminating his or her relationship with the company. Further, it could allow the employee to cash-in on the grant at some predetermined future date (for example, upon retirement), by requiring the company to redeem the employee's equity for a fixed (or formulaic) price.

Conclusion

Equity incentive plans and buy/sell agreements can be structured in any number of ways in order to achieve the employer's and the employee's objectives. Careful planning must be undertaken in order to avoid adverse tax consequences and to ensure that any favorable tax treatment that is available is achieved, while simultaneously using these plans for their intended purpose—to attract, retain and motivate the best and brightest.

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