Employee Equity Compensation Strategies for Start-ups

Carter Mackley
Jenny Coates

For Keiretsu Forum Northwest Chapter

May 2, 2012

Employee Compensation - The Fundamental Consideration

How to grant equity in appreciating company without creating immediate tax liability for grantee.

Entity Types

- Corporation
- S Corporation
- LLC taxed as S corporation
- LLC taxed as partnership

Other Considerations will Dominate Entity Choice

You may be a corporation because:

- Predominant model for tech start-ups (equity offerings and IPOs)
- VCs usually won't invest in LLCs
- You will have foreign or non-profit investors
- Retention of earnings/reinvestment of capital
- Qualified small business stock
- Section 368 tax free reorganizations available
- No self-employment tax

Other Considerations will Dominate Entity Choice

You may be an LLC (taxed as partnership) because:

- Single level of tax
- Investors can use operating losses
- Business will be operated for cash flows
- Tax-free distributions of appreciated assets
- Tax-free contribution of appreciated property
- Special allocation of tax attributes
- Flow through entity that allows: multiple classes of units, foreign members, over 100 members.
- Debt included in basis
- Partnership redemptions deductible

Other Considerations will Dominate Entity Choice

You may be an S corporation because:

- Simple flow through entity with single level of tax
- Easy to convert to C Corporation
- Can minimize employment taxes
- Investors can use operating losses
- Business will be operated for cash flows
- Traditional stock options are available
- Fringe benefits not included in income

But: limited to 100, domestic shareholders, one class of stock. Partnership redemptions not deductible.

Employee Compensation - the Fundamental Consideration

How to grant equity in appreciating company without creating immediate tax liability for grantee.

Predominant Start-up Equity Compensation Arrangement

- Founders issue restricted stock to each other that vests over 3 to 5 years.
- Stock is issued early when the value is low.
- Founders make 83b election to preserve capital gains treatment for stock as it vests.
- 10 to 20 percent of equity is allocated for Company stock option plan.
- Employees receive stock options with exercise price set at fair value of the company at time of grant.
- Employee pays exercise price or “net exercises” upon liquidity event (reaping appreciation in value since grant)

Issues

- Incentive Stock Options versus non-ISOs
- Exercise price determination (led to 409A)
- Profits interests for LLCs.

ISOs versus non-ISOs

Example of How Stock Options Work

What is 409A?

What is 409A cont.

Profit's Interests for LLCs

Profit’s Interests for LLCs cont.