Private Company Equity Compensation

Overview

- When a private company grants equity to its service providers (employee, independent contractor, director, etc.), the most common types of awards include: interest in the partnership/LLC (e.g., a profits interest), restricted stock (RS), restricted stock units (RSU), and stock options (both non-qualified (NQSO) and incentive (ISO)). In addition, a private company may also offer the opportunity for its service providers to purchase stock and/or restricted stock. Though the types of awards might be similar to those received by their counterparts at public companies, service providers with equity compensation in a private company (whether in startup, growth, or pre-IPO phase) face unique obstacles and added complexity. This Insights aims to provide various planning opportunities and considerations for these individuals.

How are Private Company Equity Grants Different?

- Lack of Liquidity: As private company stock is not listed on a stock exchange and resales are restricted by both the U.S. Securities and Exchange Commission (the SEC) and company-specific rules, it generally has little or no liquidity.
- Greater Use of Stock Options: In comparison to public companies, private companies (especially in their early years) tend to issue stock options (commonly ISOs and/or "early exercise" options) over other types of equity.
- Valuation: They require a §409A valuation, which may include independent third-party appraisals. *For more details, see the §409A section below under stock options*.
- Vesting Conditions: Vesting typically occurs more frequently than vesting of public company grants. For example: options vesting monthly rather than annually, or a tranche of a grant cliff vests at one year and then monthly thereafter.
- Double Trigger Vesting: Restricted stock and RSUs are often subject to a double-trigger vesting, which means there are two conditions which must be met. Most commonly the first trigger is upon a specific time frame (e.g., three years) and then the second trigger would be the occurrence of an event (e.g., IPO).

- Company Rights: Private companies often retain certain rights upon the grant of equity. These rights may include a right of first refusal, a stock buyback, and/or repurchase rights. A right of first refusal gives the company (as holder) the contractual right for a stated period to buy the equity from the service provider (as owner) before the service provider is entitled to enter into that transaction with a third party. A stock buyback is a voluntarily program where the company buys its own stock back from private investors and/or the marketplace in order to re-invest in itself. A repurchase right gives the company the right to buy back stock from its shareholders (at a price determined by the terms of the agreement), provided that certain conditions are met.
- Preferred Shareholder Rights: Upon the sale of the private company, preferred shareholders would have the right to any proceeds before others.
- Tax Complexities: Grants are often designed to work around standard tax rules.
  - For example, a private company only uses one standard agreement for ISOs; however, the grant loses ISO treatment due to the recipient being a non-employee or with early exercise of options over the $100,000 threshold.
- Qualified Small Business Stock (QSBS) Eligibility: QSBS is treated favorably for capital gains purposes if both the investor and the company meet certain requirements. *For more information, see the Tax Policy & Research Insights "Understanding Qualified Small Business Stock Insights".*

Substantial Risk of Forfeiture (SRF)

- A substantial risk of forfeiture is when the right to receive compensation is subject to a certain condition being met or the future performance of substantial services by the service provider. The general rule is that once a service provider's compensation is no longer subject to a SRF, it will be subject to taxation. There are certain situations, however, where this general rule does not apply and the timing of taxation differs. For example, if a service provider makes a §83(b) election on a property interest (subject to SRF) at grant or if an equity grant is deferred after the SRF has been met.
- When determining whether a SRF exists, one must confirm that there is (1) some likelihood of occurrence and (2) some likelihood of enforcement. Only a restriction that lapses (and not a non-lapse restriction), can create a SRF. A lapse restriction is a restriction that has the potential of going away after a definitive period of time and it cannot be factored into the valuation. A non-lapse restriction, on the other hand, is a permanent restriction that will never go away and must be factored into valuation.
- To illustrate this point, below are common examples of conditions that rise to the level of SRF and conditions that do not.
  - Examples that create a SRF: time vesting with forfeiture upon either voluntary termination or involuntary termination without cause prior to vesting, a company repurchase right for potentially less than fair market value (that lapses at some point), performance hurdles, and/or a need to avoid a violation of §16(b) short-swing profit rules.
  - Examples that do not generally create a SRF: general transfer restrictions, lockup agreements, non-compete provisions, compliance with a company's insider-trading

policy, involuntary termination for cause, a repurchase right that either does not lapse or is at current FMV, company insolvency, and death.

- Note that a non-compete provision is presumed to not meet the level of a SRF. Though there may be limited situations where that presumption can be rebutted, it can never create a SRF for §409A purposes.

Planning Opportunity: §83(b) Election

- Under IRC §83(a), when restricted stock or other restricted property is received in connection with the performance of services, the excess of the fair market value (FMV) of the property (if any) over what was paid for the property is taxed to the person providing the services as ordinary income in the first year that the property is transferable and not subject to a SRF. Thus a service provider pays no tax at the grant of restricted stock and instead any tax is payable upon vesting when the restrictions lapse using the stock's value at vest. However, recipients of restricted stock or other actual property interests can make a §83(b) election and be taxed as of the date of grant using the value at grant.
- In order to make a §83(b) election, the service provider must have received an actual property interest. This is why a service provider cannot benefit from this tax opportunity when the applicable grant is for RSUs or stock options (however, see the *Early Exercise Stock Options* section below for additional details).
- *For more information, see the Compensation & Benefits Policy Research Insights "How & When to Make a §83(b) Election" and the Tax Policy & Research Technical Advisory "Section 83(b) Issues Related to ISOs".*

Planning Opportunity: §83(i) Election

- IRC §83(i) permits a "qualified employee" of an "eligible corporation" to elect to defer income attributable to a stock option or RSU received in connection with the performance of services for up to five years.
- Eligibility for this opportunity is very limited due to how the IRS defines "eligible corporation". A company is an "eligible corporation" if no stock of the employer (or any predecessor) is readily tradable on an established securities market during any preceding calendar year. Additionally, the company must have a written plan under which, in the calendar year, not less than 80% of all employees who provide services in the United States are granted stock options or RSUs with the same rights and privileges to receive qualified stock (though the amount granted to each employee need not be identical). This test must be met with respect to options only or RSUs only, not a combination of the two.
- *For more information, see the Compensation & Benefits Policy Research Insights "Qualified Equity Grants by Private Companies under IRC §83(i)".*

Issue Spotting: Profits Interests (a.k.a. Carried Interests)

- A profits interest (also referred to as a carried interest) is a form of private equity that allows organizations taxed as partnerships (commonly LLCs) to offer something closely structured to a stock option/stock appreciation right. They are a valuable tool in that they present a way for a partnership, in many instances, to turn compensation into capital gains rather than ordinary income.
- When a profits interest is designed to comply with certain IRS safe harbor conditions, it's often referred to as a "qualified profits interest" and will be taxed at capital gains rates upon a liquidation event. Though the IRS (through Revenue Procedure 2001-43) makes it clear that a §83(b) election is not required for these qualified profits interests, it is best practice for a recipient to make a "protective" §83(b) election on unvested awards showing a $0.00 value at grant, should the IRS later determine the profits interest is not qualified.
- By definition, a qualified profits interest has no value at grant. Since the value is $0.00, there is no risk to making the §83(b) election since there is no income inclusion. Although the growth on a qualified profits interest is generally taxed at capital gains rates upon liquidation regardless of the election, a §83(b) election is still critical to ensure capital gain treatment. A qualified profits interest disposed of within 2 years from the date of grant will lose its status as a qualified profit interest. Therefore, without the §83(b) election, there would be risk that the IRS could argue the profits interest had value at grant and such value (along with appreciation) would be subject to ordinary income tax upon vest. Thus a protective §83(b) election is extremely important.
- *For more information, see the Compensation & Benefits Policy Research Insights "The Basics of Profits Interests".*

Issue Spotting: Restricted Stock (RS)

- It's important to remember that restricted stock and restricted stock units are not the same. While restricted stock is an actual property interest, an RSU is a mere promise.
- RSUs are income taxable at delivery and FICA taxable at vest. If delivery of an RSU is delayed post vest, it will become deferred compensation and be subject to §409A rules. Restricted stock can never be deferred past vest.
- When a service provider is granted restricted stock that is subject to a SRF, it is taxable at vest on the value at vest. If, however, the service provider chooses to make a §83(b) election, it becomes taxable at grant and the amount includable in income will be the FMV of the stock on the date of grant less what the service provider pays for the stock.
  - For example, RS is typically granted with no expectation of payment for the shares or the payment of a nominal amount. The most common SRF is complete forfeiture of the shares should the service provider terminate early as a "bad leaver" (voluntary termination without a good reason).
- It is not uncommon for service providers to be given the opportunity to purchase private company stock. Even though the stock is purchased, there may still be terms that rise to the level of a SRF.

  - An example of a SRF in this scenario is a lapsing repurchase right at the lesser of the original purchase price or the then current FMV, which could potentially result in the company repurchasing the stock at the original purchase price after significant appreciation.
  - When a SRF applies to stock purchased at FMV, absent the §83(b) election, the service provider will have ordinary income for any growth between the purchase date and the lapse of the SRF (i.e., at vest). With the §83(b) election, the service provider has no income to recognize on shares purchased at FMV, and any future gain would be capital – thus no risk to making the §83(b) election. Therefore, in this scenario, it is critical for the service provider to make a §83(b) election.

Issue Spotting: Stock Options

- **Compensatory Warrants**
  - Compensatory warrants are mechanically the same as stock options and are treated the same for income tax purposes. They differ from stock options in that there is no formal plan (i.e., they can be issued on an ad hoc basis) and they are dilutive (i.e., the company doesn't actually issue new shares upon exercise of the warrant, rather exercise results in a decrease in the ownership percentages of existing stockholders).
- **Early Exercise Stock Options**
  - An early exercise stock option is one where the agreement permits (but does not require) the recipient to exercise the options prior to their vesting date. To spot an early exercise option, the agreement will often state that the grant date and the exercise date are the same, with vesting occurring at a later date. Upon early exercise, the recipient will receive shares of restricted stock.
  - Though a service provider cannot make a §83(b) election on a stock option (since it is not an actual property interest), when he/she chooses to early exercise that stock option, they can make a §83(b) election on the restricted stock received.
    - Making this §83(b) election can provide numerous tax advantages. For example, the service provider would receive capital gain treatment for future growth which could be significant if the stock significantly increases. However, with any §83(b) election, the service provider must also evaluate potential risks. For example, the service provider would be purchasing stock they could ultimately forfeit (and only be able to take a loss for the amount paid, not taxes paid) or which could decline in value (they would have paid more in taxes than ultimately needed to).
    - The §83(b) election starts the long-term capital holding period for the stock.
  - If the service provider does not make the §83(b) election, they would pay ordinary income tax on the spread at vest rather than at exercise. When determining whether to early exercise an option, below are some considerations:
    - The ability to early exercise gives the service provider the opportunity to keep the equity as an option or to convert to restricted stock. It is not an all or nothing decision; therefore, one can decide to early exercise only a portion of the options.

    - The decision to early exercise is often best done soon after receiving the option in order to keep any taxable spread minimal (which in turn keeps the ultimate tax and risk lower).
    - Knowing the correct exercise price is critical as any out-of-pocket amount will be the service provider's risk should forfeiture occur.
    - The decision may be easier if the SRF is merely a repurchase right by the company since the SRF is not complete forfeiture should the service provider be considered a bad leaver, rather it is merely a repurchase at potentially less than FMV (typically what the service provider paid for the stock). Service providers must ultimately not only be comfortable with the possibility of losing their entire investment due to a possible decline in value, but also with the fact that a capital loss cannot be taken on the taxes paid where the stock is forfeited. This is particularly relevant if the employer is in its early stages and any potential liquidity event is several years away, it is a scenario that all option holders should consider before investing their own capital.
    - Any potential changes to capital gains rates, as a significant increase would make this approach less attractive and vice versa.
    - It's more common to see monthly vesting when it comes to private company early exercise options. One reason for this more frequent vesting is that it reduces the forfeiture risk more rapidly where an early exercise has been made.

- **Incentive Stock Options (ISOs)**
  - Known as the "$100,000 Rule," only $100,000 worth of ISOs can first become EXERCISABLE (not vested, as often thought) in any given year. When determining whether the threshold will be met, option grants need to be reviewed on an annual basis and the value is based on the FMV of the stock on the date of grant. If more than $100,000 of ISOs will first become exercisable in a given year, not all of the options will qualify for ISO treatment. Once the limit is reached, any additional options first becoming exercisable in that year will be treated as NQSOs. When determining which grants will retain ISO treatment, the employee will look to the grant dates - the older grants will remain ISOs and the newer grants will have NQSO treatment.
  - A company can only grant ISOs to employees, so any ISOs granted to a non-employee (e.g., non-employee director or consultant) are automatically NQSOs. Private companies are less likely to plan for these rules and leave it up to the service provider to determine. For example, most companies only have one equity agreement form, so even though it may identify the grant as intending to qualify as ISOs, the applicable service provider may actually be receiving NQSOs.
  - If an employee intends to early exercise before spread builds up, it's generally better for them to receive a NQSO (in addition to the $100,000 rule referenced above and the ISO holding period). With ISOs, the regular tax capital gain holding period will NOT begin until vest, since the §83(b) election only pertains to the Alternative Minimum Tax. A §83(b) election on the restricted stock received from the exercise of a NQSO does start the long-term capital gain holding period. If early exercising before spread has built up, the tax preferential treatment of the ISO over the NQSO is irrelevant since there is no income to be recognized either way.

- With ISOs, the analysis on early exercising is more difficult. Capital gain treatment can still possibly be achieved on all appreciation without the risk of early exercise given ISO tax preferential treatment. However, this will depend on the employee's overall tax situation at the time of exercise and the ability to meet the requisite ISO holding period.
- It's less likely for a holder of private company ISOs to disqualify those ISOs from preferential tax treatment given the limited ability to have a disposition.
  - Note that gifting of an ISO is considered a disposition.
  - Note that a company liquidity event is out of an employee's control and could lead to a forced disqualification.
    - *For more information, see the Compensation & Benefits Policy Research Technical Advisory "Incentive Stock Options" and the Compensation & Benefits Policy Research Insights "Incentive Stock Options v. Non-Qualified Stock Options*."

- **§409A Issues**
  - Internal Revenue Code section 409A regulates nonqualified deferred compensation. A violation of these rules can result in significant penalties and early income inclusion to the service provider.
  - Granting a stock option with a strike price less than FMV at grant (sometimes referred to as a discount option) is generally a §409A violation since the option terms are likely unable to comply with the §409A rules. The strike price must be equal to or greater than the FMV on the date of grant. This rule is based on the fact that if the exercise price is less than FMV at grant, the recipient will effectively have built in spread from the start. If the option is not required to be exercised by March 15th following the year of vest, it would be deemed nonqualified deferred compensation subject to §409A. Any option that allows the service provider to choose when to exercise during the stock option term (which is the very nature of a stock option) is in violation of the §409A rules.
  - This becomes an issue with private companies as it is much harder to determine FMV. For this reason, many private companies will get a "409A valuation" done on a date close to the grant of the option.
  - When determining FMV, the value must be determined by the reasonable application of a reasonable valuation method. An appraisal is not required, but it can be very helpful (especially one completed by an independent third party). For reference, the IRS has provided various Safe Harbor methods. A valuation is stale after twelve months or if there is a material development (e.g., a significant change in income projections).
    - Note that the value for §409A purposes may differ from other values of the stock, such as trade prices under a secondary market since reasonable lack of marketability or other discounts can be factored into the §409A valuation.
  - If there is a §409A violation related to a strike price less than FMV, the service provider will be liable for the penalties (not the employer). The service provider will be subject to income tax on the spread as of December 31 of the year of vest, regardless if exercised. Further, in each subsequent year prior to the exercise of the options, any additional unrealized gain as measured on December 31 of such year is includable as income. The amounts so taxed as income serve to increase the option holder's tax basis in the options

to avoid "double taxation" of the previously taxed income in the year the options are actually exercised. This tax is due at vest regardless of whether the option was exercised. Each time income is recognized, it will be subject to a 20% penalty. An additional premium interest tax may also be imposed on the §409A income from the date of vest at the rate of one percent above the IRS underpayment rate. Although computed like interest, this is a tax that itself may be subject to interest and penalty charges.

    - Beware that grant agreements may have language where the service provider is waiving/releasing any right to sue over §409A violations. It's best practice to have "make whole" language for a company error resulting in a §409A violation.

- **Exercise Methods**
  - The exercise methods for private company stock are limited in comparison to those available for stock options received from a publicly traded company.
  - As there is no market for the private company stock, and therefore no sales, the service provider must pay out of pocket to exercise and often to pay the associated tax as well.
  - Private companies often do not offer share withholding as they don't have the extra cash on hand to pay the costs and applicable taxes.
  - Swapping of currently owned shares may be an available method.
- **Financing Exercises**
  - Company Loans
    - See below section "Planning Consideration: Private Company Loans".
  - Third Party Lenders
    - Over the last decade or so, an industry has developed which provides financing to private company option holders. As opposed to banks, these companies either provide the financing themselves (e.g., they manage a hedge fund specifically for this purpose) or they may simply act as an intermediary between investors and option holders. Essentially, these companies loan an individual the funds he/she needs in order to exercise options and pay the corresponding taxes.
    - Each company may structure their financing differently. These are not traditional loans with annual percentage rates and fixed repayment dates, but rather contractual agreements where the option holder agrees to repay the funds (plus fees) after the stock becomes liquid (e.g., after an IPO). As these are generally non-recourse loans (meaning that should the company fail the option holder is not responsible for paying back amounts borrowed beyond collateral), the financing company generally requires the option holder to add a portion of the upside to the repayment amount (e.g., a certain number of shares or percentage). The repayment would be made after any lockup period has expired and the option holder is then free to dispose of their shares in the public market.
    - The tax consequences related to this type of loan can get very complicated and require a detailed analysis. For example, a question that will need to be determined is whether it is a pre-paid forward contract or an upfront sale with an open contract.

Planning Consideration: Private Company Loans

- As opposed to public companies, who are barred under Sarbanes-Oxley from offering loans to executives, private companies often provide loans to their service providers for the purpose of exercising their options.
- An employer may offer a service provider the opportunity to purchase shares of the employer's stock and lend the purchase price for the shares to the service provider in return for the service provider's promise of repayment, with interest, over a specified time.
- These must be bona fide loans and not disguised compensation (e.g., a cash advance). The key is making sure a valid debtor-creditor relationship exists (i.e., what conditions would a bank require before making such a loan and expectations of repayment?), although the company can offer somewhat friendlier terms such as a lower interest rate.
    - Key things that should be reviewed: the existence of a promissory note to be signed by both parties, the receipt of cash payments according to a specified repayment schedule, interest charged at a stated interest rate, security for the loan beyond the shares being purchased (nonrecourse vs. recourse), any expectation of forgiveness by the company at the time of the loan or an expectation of forgiveness based upon certain events as to services to be provided or in exchange for a bonus is a major red flag, and qualification (e.g., whether the company conducted a financial background investigation or credit check to evaluate the creditworthiness or ability to repay).
- A recourse loan is important when attempting to establish a valid debtor-creditor relationship. Both recourse and nonrecourse loans allow lenders to seize collateralized assets after a borrower fails to repay a loan. After collateral is collected, lenders of recourse loans may go after a borrower's other personal assets if they have not recouped all of the loan proceeds. With a nonrecourse loan, lenders can collect the collateral but may not go after the borrower's other assets.
- A nonrecourse loan from an employer to purchase company stock may be treated as the employer's grant of a compensatory option to purchase the employer's stock. In this case, the result could be the conversion of potential lower-rate capital gain on the shares appreciation into higher-rate ordinary compensation income. Also, if a nonrecourse loan from an employer is provided to exercise a stock option, the option will not be considered exercised for tax purposes (computation of the taxable spread) until the loan is substantially repaid.

Planning Consideration: Liquidity Programs for Private Company Stock

- When a private company takes longer to go public or get acquired, service providers holding vested equity may look to various programs to exchange those shares for cash. Examples of these types of liquidity programs include company buyback programs, secondary markets, packaged sales to outside investors, and internal employees market.
    - A common secondary market is one where a private company creates a platform which connects service providers with outside investors. In this market, the service provider is given the opportunity to sell illiquid assets while the outside investor is given the unique opportunity to purchase pre-IPO equity.

- Eligibility for liquidity programs needs to be evaluated under any possible company-specific rules. For example: only current employees may be eligible for a liquidity program or only previously exercised options. Additionally, company rules often limit the amounts that can be sold.

Planning Consideration: Lockup Periods

- A lockup (sometimes called a “market standoff” agreement) is a contractual restraint a company imposes on selling one’s shares. It is separate and distinct from any securities law requirements and holding periods that may apply. The company defines the restrictions and reports them in the IPO Prospectus (which is a part of the Form S-1).
- Private company insiders holding company stock may often be subject to a lockup period upon an IPO or acquisition. The insider will not be allowed to sell stock subject to this lockup during the lockup period. Lockup periods are used to address the potential concern that if an insider sells their shares soon after an event, the company's stock price will fall and thus undermine the price of the IPO and the post-IPO trading market.
- Lockups do not apply in a direct listing (i.e., shares can be sold without delay once the stock is listed on a stock exchange).
- Most lockup periods last for 180 days, though some may be as short as 90 days. In the case of a private company going public via a SPAC, SPAC sponsors will generally be subject to a one-year lockup. This can create staggered releases of shares into the market after the acquisition, and may lead to the target company holders to also have a one-year lockup to align interests.

Planning Consideration: Change-in-Control (CIC)

- When a disqualified individual receives excess golden parachute payments upon a change in control, the company is denied a corporate tax deduction (IRC §280G) and the employee is subject to a 20% excise tax (IRC §4999) on such payments.
- In calculating whether an excess golden parachute payment exists, certain payments made by a company are exempt. These exemptions include: payments of reasonable compensation for services after the CIC, payments from a vested retirement plan, payments from a company that is not publicly traded if 75% of non-impacted shareholders approve, and payments with respect to a small business corporation.
- Shareholder Approval Exception: With respect to payments being made to a disqualified individual of a privately held corporation, the application of the excise tax can optionally be put to vote by non-impacted shareholders (those not subject to the excise tax). Ultimately, if it’s decided to put it to a vote and less than 75% approve the transaction, the excise tax is in place; however, if 75% or more approve there will be no excise tax exposure to the executives.
    - The golden parachute payments must be made contingent upon the vote, meaning the disqualified individuals must agree to waive the excess payments all together if the 75% approval threshold is not met.

  - The vote cannot occur more than six months prior to a CIC and the CIC cannot be made contingent upon the vote.
  - Prior to the vote, there must be adequate disclosure to all persons entitled to vote of all the material facts concerning all material payments which would be considered golden parachute payments.
- For more information, see the Compensation & Benefits Policy Research Insights "Golden Parachutes & Change-in-Control Issues".

Planning Consideration: Key Documents

- A service provider who receives equity from a private company will want to ensure they have copies of all the appropriate documentation in order to properly evaluate the grant. Typical documents include the actual grant agreement describing the terms of the service provider's award, an overall plan document explaining the company's equity plan, and either the Shareholder Agreement or the Partnership/LLC Agreement.

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