EQUITY INCENTIVES IN THE U.S.

Taavi Annus

April 29, 2021

Standard Equity Incentives for U.S. Startups

- Stock Options
  - Allows recipient to purchase shares for pre-determined exercise price
  - Incentive Stock Options (ISOs) (limited to employees)
  - “Non-Qualified Stock Options”
- Restricted Stock (used mostly in very early stages)
- Investors typically expect startups to set aside an equity incentive pool for employee equity incentives (usually 10-20% of fully-diluted capitalization)

Standard Option Terms

- Time based vesting: 4 year vesting schedule, with 1 year “cliff”
  - No accelerated vesting provisions
- Exercise price equal to fair market value of a share of common stock on date of grant
- 10 year term; often must exercise within a certain time period after termination of employment (required for ISO treatment)
- For employees outside U.S., companies typically use supplements to equity incentive plan to provide for country-specific terms

Equity Incentive Taxation

- All Stock Options:
  - No income tax on grant or vesting
- Incentive Stock Options:
  - May avoid tax on exercise (other than “alternative minimum tax” impact), but sale of shares taxable (typically at <u>currently</u> favorable capital gains rates (15% or 20% + state + local) if held stock for one year – not the case if exercise in connection with sale of company)
- Non-Qualified Stock Options:
  - Taxed on exercise (difference of FMV upon exercise and exercise price) at ordinary income rates (up to 37% + state + local + social security), and then upon sale of stock if further appreciation in value
- Restricted Stock (and similar awards) typically taxable upon vesting
  - May elect to pay taxes on restricted stock upon grant (with “83(b) election”) – favorable at very early stages; 83(b) also used in connection with exercise of non-vested stock options (“early exercise”)

Other Equity Incentives

- Performance-Based Awards
- Restricted Stock Units (RSUs)
  - Not often used in startups – taxable upon vesting
  - Much more common in mature, especially in case of publicly traded companies: shares issuable upon vesting are used to cover taxes
- Stock Appreciation Rights
- Phantom Equity
- Profits Interests (“pass-through” entities)

BRYAN CAVE LEIGHTON PAISNER

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