Equity-Based Compensation: Stock Options, Incentive Compensation, & Related Founder Issues

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What is a Stock Option?

A right to buy, over a specified period of time, a specified number of shares of common stock at a specified price

Option Plan (Equity Incentive Plan)

SEC Rule 701

Options are securities that must be issued in compliance with federal and state security laws
Granting an Option

Who can a company grant options to?

Who in the company can grant options?

ISOs vs NQSOs
Terms of an Option and Vesting

Option Term

Vesting

Fractional Shares

Termination of Vesting Period
Exercise Price

"Strike Price"

Price an option holder must pay to purchase the company's shares

Typically set at the fair market value of the company's common stock as of the date the option is granted

Publicly Traded Companies vs Private Companies
Exercise an Option

- Mechanisms for exercising an option are set out in the option agreement.
- Can be exercised to purchase some of or all the then vested shares.*
- Minimum exercise amount
- Surrendering shares of the company's stock already owned by the option holder
- "Cashless Exercise"
Nonqualified Stock Options
The Default Form of Option

- Nonqualified Stock Option (NQSO)
  - Default for of a stock option
    - A stock option that does not meet the requirements of an incentive stock option.
    "Non-statutory options"
Tax Treatment of NQSOs

No tax deduction for the company

Company records a compensation expense for accounting purposes equal to fair value at time of grant

Taxes assessed upon exercise:
- Option holder recognizes ordinary income
- Company takes a tax deduction in that amount

- Section 83 of the Internal Revenue Code
- Wages
- Credits towards employees' tax obligations
- Private company context
- Why is it important for an employee to have the financial resources to pay the required tax withholding amount of an option?
- Extending the exercise period for departing employees
Restricted Stock Compared to Stock Options

- Two main differences between a restricted stock issuance & a stock option grant:
  1. Restricted shares are acquired immediately
  2. Different tax treatment applies
- Short period of time for employees to accept the grant
- Can be granted to new hires and current employees
- How does an employee accept the grant?
- Typically pays the purchase price for restricted stock up front
Application of Section 83

• Tax Treatment
- If a company pays for a service by issuing stock the value of that stock is taxable income to the person who receives it.
- "Congress made section 83(a) applicable to . . . property transferred 'in connection with . . . services' not just compensation for employment."
- What happens when a service is not fully provided?
The Section 83(b) Election

Advantages of the §83(b) Election

Disadvantages of the §83(b) Election

Holding Period Advantage
Questions