MAYER | BROWN

All the Buzz:
The Latest Developments for Emerging & Tech Companies @ Silicon Slopes

Hot Topics in Equity Compensation & Tax Issues

Ryan J. Liebl
Partner, Chicago
+1 312 701 8392
rliebl@mayerbrown.com

Remmelt Reigersman
Partner, Northern California (San Francisco & Palo Alto)
+1 415 874 4259
rreigersman@mayerbrown.com

November 9, 2022

Agenda

- Advantages and disadvantages of different types of equity awards for private companies
- The benefits of "Qualified Small Business Stock" and how to qualify
- Common deferred compensation pitfalls to avoid
- Series FF stock: a hybrid between common stock and preferred stock
- An explanation of an "Up-C structure" and its benefits

Advantages and Disadvantages of Different Types of Equity Awards for Private Companies

Private Company Executive Compensation

- Public Company and Private Company Executive Compensation
  - Both types of companies are trying to “pay for performance” and align executives’ interests with shareholder interests.
  - Shareholder interests are very different:
    - Public company shareholders are generally diverse and have a range of interests (although largest investors are typically institutional investors) and a range of ownership timelines (no horizon on investment).
      - Annual equity grants with philosophy that can change year to year; easier to replace executives.
      - Equity plan must be reloaded every few years; institutional shareholders track burn rate.
    - Private companies with PE ownership have specific investment return timetable.
      - One-time grants at time of investment of PE firm; harder to reward executives who leave midstream or who join company midstream.
    - Other private companies tend to make grants at time of rounds of investment.

Private Company Executive Compensation

All the Buzz

- In an ideal world, executives would prefer an equity award that:
  - provides tax deferral of any gain received until such time as the equity is sold (*i.e.*, when actual value is realized);
  - results in capital gain treatment on such amounts (rather than ordinary income rates); and
  - does not require the executive to put any personal money at risk.
- Profits interests are the only equity award that gets close to these three goals.
- Note that the company loses the deduction though for amounts that are taxed as capital gain.
- In the corporate structure, executive has to put money at risk to get capital gain tax treatment.
- Incentive Stock Options get close to these three goals but have a value limitation that limits usefulness for senior executives.

Private Company Executive Compensation

- Private Company (Early Stage) Typical Executive Compensation Package
  - Base Salary-very low
  - Annual Bonus-very low
  - Restricted Stock for founders and stock options for founders and other employees (often incentive stock options)
- Private Company (VC Investors) Typical Executive Compensation Package
  - Base Salary
  - Annual Bonus
  - Stock Options (both incentive stock options and nonqualified stock options)
    - Early exercise for restricted shares with Section 83 election frequently permitted
  - Late stage highly valuable private companies are starting to grant “Facebook RSUs” more frequently; but Section 409A analysis is not clear and is complex.
  - Late stage highly valuable private companies also face liquidity issues for founders for early equity awards. Tension with stock option grants and Section 409A. Consider FF stock solution.

Private Company Executive Compensation

- Private Company (PE Owned) Typical Executive Compensation Package
  - Base Salary
  - Annual Bonus
  - One-Time Profits Interest Equity Grant (or stock options if operating subsidiary is a c-corp)
  - One-Time Capital Interest but usually only if co-investment (this may also include a rollover investment requirement at time PE firm buys company for certain executives)
- Public Company Typical Executive Compensation
  - Base Salary
  - Annual Bonus (formulaic for disclosure purposes and not discretionary)
  - Annual Equity Grants
    - Options-not as common anymore
    - Restricted Stock Units
    - PSUs

Nonqualified Stock Options

All the Buzz

- Nonqualified Stock Options (NQSOs) entitle a recipient to purchase a share of stock in the future for a price equal to the FMV of a share on the date of grant (right to exercise not permitted until after vesting).
- Recipient will incur ordinary income tax on the date of exercise on the total FMV of the shares received minus the total amount of exercise price paid.

Nonqualified Stock Option

- Advantages:
  - NQSOs allow the recipient to defer taxation until the recipient chooses to exercise the option and recognize the taxable gain (up to ten year term normally). Grant and vesting are not taxable events.
  - Company will receive a deduction equal to the amount included in income on exercise.
  - Recipient does not have to risk personal funds or invest prior to liquidity event.
  - Exempt from Section 409A if requirements are met.
- Disadvantages:
  - Recipient will pay ordinary income tax on the gain on exercise and will not get capital gains tax treatment.
  - Section 409A valuation (either determined by board or third party) for exercise price.
  - Company must issue actual shares on exercise and have employees as shareholders (normally requires more complicated shareholder agreement).
  - Can lose retention value if company is underwater.

Incentive Stock Options-Only Corporations

All the Buzz

- Incentive Stock Options (ISOs) also entitle a recipient to purchase a share of stock in the future for a price equal to the FMV of a share on the date of grant (right to exercise not permitted until after vesting).
- If certain requirements are met, recipient does not pay tax until such time as the shares received after exercise of the ISO are sold, and then recipient will only pay capital gain taxes on the gain on the shares sold above the exercise price rather than ordinary income tax for US federal tax purposes (please note, however, there is income inclusion at the time of exercise for purposes of the alternative minimum tax for employees subject to the alternative minimum tax).
- If the requirements are not met, the ISO is taxed generally the same as an NQSO.

Incentive Stock Options-Only Corporation

All the Buzz

- Advantages:
  - ISOs allow the recipient to defer taxation until the recipient chooses to exercise the option and recognize the taxable gain (up to ten year term normally). Grant and vesting are not taxable events. Exercise is not a taxable event (except for inclusion for AMT purposes).
  - Recipient does not have to risk personal funds or invest prior to exercise. However, to get preferential tax treatment, recipient must pay exercise price and hold shares for at least one year of risk.
  - If requirements are met, recipient can pay only capital gains taxes rather than ordinary income. Exempt from Section 409A if requirements are met.
- Disadvantages:
  - Limitations on grants to $100,000 worth of shares that become exercisable per year for ISOs in total. Company will lose the deduction.
  - Section 409A valuation (either determined by board or third party) for exercise price.
  - Company must issue actual shares on exercise and have employees as shareholders (normally requires more complicated shareholder agreement).
  - Can lose retention value if company is underwater.

Restricted Stock

All the Buzz

- Shares of Restricted Stock (RSAs): RSAs are a transfer of a share to the recipient on the date of grant that is subject to a risk of forfeiture if vesting conditions are not satisfied. Recipient is shareholder on date of grant (but right to vote and receive dividends can be restricted).
  - Recipient can choose between taxation under Section 83(a) or 83(b) of the Internal Revenue Code.
    - Section 83(a)-Recipient will incur ordinary income tax on the date of vesting on an amount equal to the FMV of the shares that become vested on such vesting date. Any subsequent gain or loss on the share is taxed as capital gain or loss.
    - Section 83(b)-Recipient will incur ordinary income tax on the date of grant on an amount equal to the FMV of the shares transferred on the date of grant. Vesting dates are then not a taxable event. Any subsequent gain or loss on the share is taxed as capital gain or loss.

Restricted Stock

All the Buzz

- Advantages:
  - If Company value is low, recipient can make a Section 83(b) election and avoid paying ordinary income tax on the gain.
  - Company will receive a deduction equal to the amount included in income, but will lose deduction for gain if recipient makes a Section 83(b) election.
  - Have retention value even if company has not gained in value.
  - Exempt from Section 409A.
- Disadvantages:
  - Taxes must be paid often on value received when stock is illiquid (either on grant or vesting). Company has to offer net withholding of shares to employee (and pay cash on behalf of employee) or require employee to pay cash on taxation. This can occur at a time when company does not have the cash to pay (nor does the employee).
  - Company must issue actual shares on grant and have employees as shareholders (normally requires more complicated shareholder agreement).

Restricted Stock Units

All the Buzz

- Restricted Stock Units (RSUs): RSUs entitle a recipient to receive a share of stock in the future if vesting conditions are satisfied. Recipient is not a shareholder until shares are distributed. Right to dividend equivalents can be included.
- Recipient will incur ordinary income tax on the date of transfer of the shares equal to the FMV of the shares received. Any subsequent gain or loss on the shares is taxed as capital gain or loss.

Restricted Stock Units

- Advantages:
  - Taxation can be deferred past vesting but the Section 409A analysis can be complicated.
  - Company will receive a deduction equal to the amount included in income on the distribution of shares.
  - Have retention value even if company has not gained in value.
- Disadvantages:
  - Recipient must be ordinary income tax on value of shares received (no opportunity for capital gain). Company has to offer net withholding of shares to employee (and pay cash on behalf of employee) or require employee to pay cash on taxation. This can occur at a time when company does not have the cash to pay (nor does the employee).
    - Companies use two-step vesting to try to avoid this result but the analysis for Section 409A on this approach is complicated and it can create other tax complications.
  - No ability to choose 83(b). RSUs must be structured to comply with or be exempt from Section 409A. Analysis is much more complicated.
  - Company must issue actual shares following vesting and have employees as shareholders (normally requires more complicated shareholder agreement).

Unvested NQSOs for Restricted Stock

All the Buzz

- Unvested Nonqualified Stock Option Exercisable For Restricted Stock: This approach could permit a recipient to effectively choose the tax approach desired between NQSOs and RSAs. Recipient can hold NQSOs or can choose to exercise unvested NQSOs and receive RSAs (subject to same vesting conditions) and make a Section 83(b) election.
- Recipient can choose to wait to exercise the NQSOs until after vesting and such NQSOs will be taxed as described for the NQSO award. Or, recipient can choose to exercise the unvested NQSOs for RSAs and make a Section 83(b) election as described for the RSA award. This approach could permit a recipient to effectively choose the tax approach desired between NQSOs and RSAs.

Unvested NQSOs for Restricted Stock

All the Buzz

- Advantages:
  - This type of award allows recipient to choose between tax result of a NQSO and RSAs.
  - If the recipient is willing and able to pay the exercise price, the recipient can receive RSAs and make a Section 83(b) election. This approach allows recipient to avoid ordinary income tax altogether and all gains will be taxed as capital gains, but recipient must bear the risk of loss of the amount of the exercise price.
  - If the recipient is not willing or able to able the exercise price, the recipient can hold the NQSOs and wait to exercise until a liquidity event. This approach allows the recipient to avoid the need to risk any amount of loss but all gains on the date of exercise will be taxed as ordinary income.
- Disadvantages:
  - Recipient must put money at risk and bear risk of loss to get capital gain tax treatment. Valuation of the company is key to understanding if this approach could work.
  - Company will lose deduction if recipient gets capital gain and Company will need to deal with issues related to actual equity being owned by employees.
  - Company must issue actual shares following vesting and have employees as shareholders (normally requires more complicated shareholder agreement).

Profits Interests-Pass Through Entity Only

All the Buzz

- Profits Interests (PIs): Type of equity interest in a partnership that entitle the recipient to a percentage of future profits of the partnership. These are typically used by private equity for companies owned in fund structure (but can be used in other structures if a pass through entity is used).
- Recipient pays tax as partner in partnership for an income allocated to the PIs. If certain requirements are met, recipient pays capital gains tax when interests are sold.

Profits Interests-Pass Through Entity Only

All the Buzz

- Advantages:
  - Recipient can avoid ordinary income taxes and only pay capital gain on the upside. No tax due on 83(b) election unlike for restricted stock.
  - Recipient gets tax deferral and does not need to put personal funds at risk to get capital gain.
- Disadvantages:
  - Employee cannot be an employee and partner of the same entity for tax purposes. Must receive a K-1 from entity in which he or she is a partner. Triggers self-employment taxes and impacts employee benefits. Structure can be used to avoid this issue but it creates more complexity.
  - Employee can be required to pay taxes in lots of jurisdictions and can be hit with phantom income.
  - Company loses deduction.
  - Company must issue actual equity interests and have employees as partners (requires a complicated partnership agreement).

Phantom Units

- Phantom Equity: Cash-based incentive plan that entitles the recipient to a cash payment based on the value of a share on certain payment events.
- Recipient pays ordinary income tax on the amount received on the payment date. Please note, a phantom award must be structured to be exempt from or compliant with Section 409A and any violation would trigger early taxation plus a 20% additional tax (plus interest and penalties).

Stock Appreciation Rights

- Cash Settled Stock Appreciation Rights (SARs): Cash-based incentive plan that entitles the recipient to a cash payment on the date of exercise in an amount equal to the difference between the value of a share on the date of exercise minus the value of a share on the date of grant.
- Recipient pays ordinary income tax on the amount received on the exercise date. Please note, an SAR can be structured to be exempt from Section 409A that is not available for phantom equity.

Cash Awards-Phantom Units and SARs

- Advantages:
  - Company can avoid complications of granting actual equity ownership to employees.
  - Company will get deduction for amount paid to executives (unless limitation of deduction for certain employees of public companies would apply to limit the deduction).
  - Section 409A compliance: SARs have their own exemption from Section 409A that greatly simplifies tax compliance. Phantom stock plans are difficult to design in a way that is either exempt from or complaint with Section 409A.
- Disadvantages:
  - Taxation: There is no opportunity for capital gain tax treatment for the executives as they would pay ordinary income on the gain.
  - Calculation issues: Phantom equity creates a circular calculation problem with the value of the actual equity. This issue becomes significant if the phantom equity represents a significant portion of the outstanding equity of the Company.

Benefits of "Qualified Small Business Stock" and How To Qualify

Section 1202 Summary

All the Buzz

- Allows a non-corporate taxpayer to exclude up to 100% of gain from sale of "qualified small business stock" held for more than 5 years
  - Annual limitation equal to the greater of $10M or 10 times the stock basis
  - Stock must be acquired after September 27, 2010
  - Stock must be acquired at "original issuance"
- Issuer requirements
  - Qualified small business
  - Active business requirement
  - No significant redemptions

Section 1202 Issuer Requirements

All the Buzz

- Domestic C corporation
  - No S corporations or partnerships
- Aggregate gross assets have never exceeded $50M
  - Cash plus aggregate adjusted bases of other property (or FMV at time of contribution)
- Active business requirement
  - At least 80% of assets used in active conduct of one or more Qualified Trades or Business
  - Qualified Trade or Business (QTB) is any trade or business **EXCEPT**
    - Health, law, engineering, architecture accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or those where principal asset is reputation or skill of 1 or more employees; Banking, insurance, financing, leasing, investing, or similar business; Farming (including raising and harvesting trees); Mining and resource extraction; Any business of operating a hotel, motel, restaurant, or similar business

Section 1202 Issuer Requirements cont.

- No significant redemptions
  - A corporation cannot redeem more than 5% of value of its stock, beginning the year prior to shareholder purchase and ending the year after. 5% is determined based on the value of the stock at the beginning of the four-year period.

Section 1202 Special Rules

All the Buzz

- Ownership through partnerships (including profits interests)
- Convertible securities, option and warrants
- Corporate transactions (e.g., merger)
- Maximum real estate holdings
- Offsetting short positions

Common Deferred Compensation Pitfalls to Avoid

Common Deferred Compensation Issue to Avoid

All the Buzz

- Voluntary reduction in current compensation when company is tight on cash in exchange for promise of repayment in future when company has more cash.
  - This occurs often with start up companies when executives are trying to be helpful.
  - This structure most likely violations Section 409A.
  - Solution is to just relinquish compensation without promise for future repayment (contractual risk but avoids tax issues).
- Signing a binding agreement that promises future compensation arrangement prior to attorney review.
  - This happens frequently with offer letters when company signs offer letter and intends to engage attorneys later to draft full documents.
  - Section 409A analysis is triggered by "legally binding right." It can be difficult to fix problems after legally binding right is established.
- Payment of compensation owed with a promissory note. This will violate 409A if taxation is deferred.

Series FF Stock: Hybrid Between Common Stock and Preferred Stock

FF Stock

- There is an issue that occurs when founders (or other employees) want to sell common stock in a fundraising round when investors are buying preferred stock. Founder wants to sell common at preferred price but that would create problems on the valuation of the common stock for any future grants of stock options.
  - To make this work, the company often repurchases the common stock from the founder (at the higher preferred price) and then issues the preferred to the investor.
- FF Stock is a class of common stock that is created to be held by founders (or other senior executives) that can be sold directly to the investors as the FF stock is automatically converted to preferred units when sold in a fundraising round.
- Because the FF stock is a separate class of stock, it can have a higher value than the common stock used in the equity plan for stock option grants.

“Up-C Structure” and its Benefits

Up-C Structure

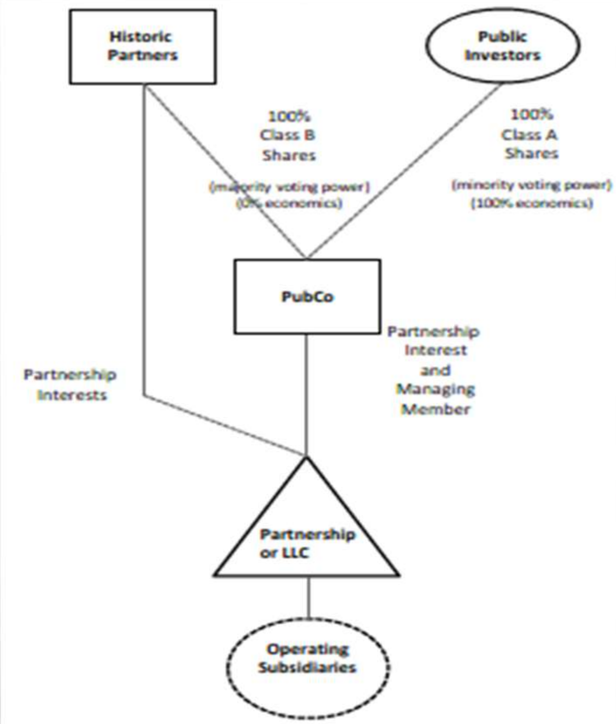
All the Buzz

- The Up-C structure has become increasingly common for IPOs of companies that have historically operated as partnerships
- The Up-C structure derives its name from the UPREIT structure. Essentially, a newly formed corporation ("PubCo") will be the entity that undertakes the IPO. PubCo will sit above an existing limited liability company (the "LLC")

Up-C Structure Overview

All the Buzz

- PubCo will be a holding company and will have as its subsidiary the LLC. The principal assets/operating business will continue to be at (or below) the LLC level
- PubCo has two classes of common stock, Class A (held by public investors) and Class B (voting power but no economic interest; held by historic partners)
- PubCo will receive the IPO proceeds and downstream the IPO proceeds to the LLC
- Historic partners may exchange their LLC interests for PubCo Class A common shares (PubCo may settle in cash) thereby obtaining liquidity
- Historic partners and PubCo enter into a "tax receivable agreement" ("TRA")
- The Up-C structure provides a range of options for making strategic acquisitions and compensating employees (*e.g.*, PubCo stock, PubCo options, and partnership units)



Up-C Structure Final State

All the Buzz

Tax Receivable Agreement

- When the historic partners sell partnership interests to PubCo (rather than stock, as in a traditional IPO structure), PubCo receives a "step-up" in the tax basis of its assets
- This tax basis step-up is allocated to PubCo's share of the historic partnership's assets (step-up allocable to intangible assets is amortizable on a straight-line basis over 15 years)
- Through a TRA the historic partners effectively capture the majority of the value associated with the PubCo's tax basis step-up
- Under the terms of the TRA, PubCo is obligated to pay the historic partners in cash an amount equal to a portion of PubCo's tax savings generated by the tax basis step-up (typically 85% of such savings)
- Payments under the TRA are effectively treated as additional purchase price paid by PubCo for its interest in the historic partnership
- TRAs often include provisions accelerating payments upon a change of control

Illustration of Potential TRA Economics

•	**Amount of PubCo Tax Basis Step-Up***	**$300 million**
•	Amortization Period	15 years
•	Annual Amortization	$20 million
•	PubCo Tax Rate (Federal & State)	25%
•	PubCo Annual Savings	$5 million
•	TRA Payout Ratio	85%
•	Annual Payment to Historic Partners**	$4.25 million
•	Total Payments to Historic Partners	$63.75 million

* Any future exchanges of partnership units for Class A shares of PubCo also may give rise to additional tax basis step-up for PubCo (thereby increasing the amounts payable under the TRA over time)

** Payments under the TRA also give rise to additional tax basis step-up for PubCo (thereby increasing the amounts payable under the TRA over time)

Additional considerations related to Up-C structure

All the Buzz

- The Up-C structure maintains continuing pass-thru treatment (single level taxation) for the historic partners with respect to their proportionate share of net income realized by the partnership
- The historic partners obtain liquidity through the right to exchange partnership units for Class A shares of PubCo
- The Up-C structure provides a range of options for making strategic acquisitions and compensating employees (e.g., PubCo stock, PubCo options, and partnership units)
- PubCo becomes the managing member of the historic partnership and the historic partners retain voting control through Class B PubCo shares
- PubCo consolidates the historic partnership for financial statement purposes

Ryan J. Liebl
Partner, Chicago
+1 312 701 8392
rliebl@mayerbrown.com

Ryan Liebl is an Employment & Benefits partner in Mayer Brown's Chicago office. Ryan focuses his practice on advising public and private companies and individual executives on executive compensation related matters, including designing, drafting and administering nonqualified deferred compensation plans, excess benefit plans, equity compensation plans and agreements, cash-based incentive compensation plans and agreements, severance plans and individual employment and separation agreements.

He also has extensive experience advising clients regarding employee benefits and executive compensation issues in corporate transactions.

Remmelt Reigersman
Partner, Northern California
(San Francisco & Palo Alto)
+1 415 874 4259
+1 650 331 2059
rreigersman@mayerbrown.com

Remmelt Reigersman is a partner in Mayer Brown's Palo Alto and San Francisco offices and a member of the Tax Transactions & Consulting practice. He concentrates his practice on federal and international tax matters. Remmelt advises on a wide variety of business transactions including sophisticated capital markets transactions and represents issuers, investment banks/financial institutions and investors in financing transactions, including public offerings and private placements of equity, debt and hybrid securities, as well as structured products.

Remmelt's areas of experience also include restructurings (both in and out of bankruptcy), debt and equity workouts, domestic and international mergers, acquisitions, reorganizations and joint ventures.

Additional Resources

FREE WRITINGS + Perspectives

OUR FREE WRITINGS & PERSPECTIVES BLOG PROVIDES NEWS AND VIEWS ON SECURITIES REGULATION AND CAPITAL FORMATION.

The blog provides up-to-the-minute information regarding securities law developments and commentary on developments relating to private placements, IPOs, and other securities topics.

SUBSCRIBE

MAYER | BROWN

Access the Blog by Scanning:

Benefits & Compensation Blog

Developments in Employee Benefits and Executive Compensation Law

Writing on the Wall

Translating Securities with Mayer Brown

FOR EXPLANATIONS OF OVER 900 SECURITIES, DERIVATIVES, FINANCIAL SERVICES, AND CAPITAL MARKETS TERMS AND PHRASES.

writingonthewall.com

Thank You

Americas | Asia | Europe | Middle East

mayerbrown.com

MAYER | BROWN