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# Executive Compensation and Benefits Issues for Start-ups and Emerging Companies

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## I. Overview

This chapter will discuss executive compensation in the start-up and emerging company space, including common market practices for start-ups that typically involve venture capital investors.

When applicable, this chapter differentiates between equity in corporations (shares of stock), partnerships (partnership interests) and limited liability companies (membership units).[1] For purposes of this chapter, the Internal Revenue Code of 1986, as amended, is referred to as the ''Code.'' Section references are to the Code unless otherwise specified. The term ''emerging company'' is used synonymously with ''start-up.''

## II. Introduction

Executive compensation in the emerging company space is based fundamentally on a negotiation, either actual or expected, between company executives and/or founders on one hand and company investors on the other hand. Although there is no one-size-fits-all executive compensation structure, there are usually norms customary to particular industries and, increasingly less so, regions. These customary compensation forms and arrangements have been established over many years through negotiations between executives and outside venture capital investors and have coalesced into a ''market standard'' for emerging companies in particular industries and regions. While a company may structure its compensation arrangements in a variety of ways before an initial outside investment, as it enters the fundraising stage it will typically face pressure to conform its compensation arrangements to market standard as a condition to being funded. Some companies match their pre-investment compensation and benefits arrangements to market standard to make for a smoother transition to market, while others prefer to design the compensation and benefits package that works best for them and address changes required as a condition to fundraising later.

In contrast with the typically passive nature of public company shareholders,[2] principal shareholders of start-ups (usually acting in their roles as officers, directors or shareholders' representatives) are often directly involved in establishing the company's executive compensation packages. The result is typically a close alignment of the executives' compensation with the interests of the shareholders (and later the investors).

Because of this close monitoring of executive compensation by those whom the executive compensation arrangements directly affect, there is relatively little criticism, public or private, of emerging companies' executive compensation arrangements. Executive compensation in the emerging enterprise tends not to be lavish or mysterious, although the compensation can be substantial if the company is successful. In any event, the starting point for the negotiations is typically whether the executive is a company founder or not.

### A. Founder Compensation

A founder (and there are typically more than one) will almost always have a substantial equity position in the company from the outset. Founders' equity awards are either granted subject to a vesting schedule or have a vesting condition subsequently imposed on them in

[1] For partnerships and limited liability companies (which are generally treated like partnerships for federal income tax purposes), equity is divided into either ''capital interests'' or ''profits interests.'' In its simplest terms, capital interests are interests in both current and future enterprise value, whereas profits interests are interests in only future enterprise value. IRS Revenue Procedure 93-27 (1993-27 C.B. 343) (defining a capital interest as ''an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership,'' which determination ''generally is made at the time of receipt of the partnership interest,'' and defining a profits interest as a partnership interest other than a capital interest).

[2] With notable exceptions for institutional investors and advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis, two well-known firms whose shareholder recommendations can hold substantial sway over shareholders. For example, among Russell 3000 companies who reported say on pay results in the 2016 proxy season, receiving a negative ISS recommendation on average resulted in 28 percent lower support from shareholders. Semler Brossy, 2016 Say on Pay Results 3 (Feb. 1, 2017), www.semlerbrossy.com/sayonpay .

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connection with a later financing, and are nearly always the subject of ''protective'' Section 83(b) elections under the Code (see ''Section 83(b) Elections '' below). Prior to any outside investment the founder typically receives little or no salary, but may participate in various company plans.

If a founder's compensation is within industry norms, then subsequent outside investors will likely not disturb those arrangements in connection with making their investment in the company. However, if certain elements in the existing compensation package are not acceptable, such as a promise of catch-up salary payments upon a financing or ''single-trigger acceleration'' of equity awards, then the founder will often be required to relinquish or restructure those arrangements as a condition to the financing. As an alternative, certain provisions may be acceptable if the investors can make up for any perceived diminishment in value of their investment in other ways, such as reducing the company's total valuation. For example, rather than according an enterprise a pre-investment value of $10 million (known as the ''pre-money valuation''), upon discovering an offending executive compensation arrangement the investors may propose to leave that arrangement undisturbed but lower their pre-money valuation of the company to $8 million. As a result, the investors would either buy a greater percentage of the company for the same proposed investment amount (more common) or buy the same percentage of the company for a lesser proposed investment amount (less common), in each case because the investors chose not to, or could not, modify a troublesome executive compensation contract.[3]

### B. Non-founder Compensation

A non-founder typically negotiates for equity as part of his or her compensation package. A non-founder typically receives less equity than founders at the same level. Unlike a founder's compensation arrangement, which may be shaped by the anticipated expectations of future investors, a non-founder executive's compensation arrangement will be shaped directly in a negotiation with the company's founders and/or current investors, all of whom typically hold large equity positions in the company. Current investors have the most to lose with regard to any dilution of their equity interests but also the most to gain if the non-founder is successful at the company. Accordingly, the current owners' company goals will almost exclusively determine non-founders' compensation. Thus, non-founders' compensation arrangements in virtually all non-distress cases in emerging companies fit ''tongue and groove'' with the interests of the shareholders.

[3] In this example, if the investors were proposing to invest $5 million at a $10 million pre-money valuation, then the investors would own one-third of the company after the financing. If they reduce the pre-money valuation of the company to $8 million, they could either still invest $5 million and own 38.5 percent of the company after their investment or invest $4 million and still own one-third of the company after the financing.

## III. Executive Compensation Rules of Thumb

### A. Founders and Executive Officers

Founders' total ownership on a voting power basis generally begins at 100 percent and is diluted with each round of investment.[4] At the same time, the founders' cash compensation may become more normalized to that of outside executives with each successive investment round. A start-up company can expect the following events to occur at each funding milestone:

- *Series A financing*: In addition to acquiring a large double-digit share of the company, the first outside investors will usually require the company to reserve an 8-15 percent equity pool for equity grants to employees and consultants, the combined effect typically being large enough to reduce the founders' ownership below 50 percent ownership post-financing. At this time, the founders may have vesting conditions imposed, together with some vesting acceleration in their equity purchase agreements and may begin taking cash compensation if they were not already doing so.

- *Series B financing*: Current investors and new investors' joint investment will likely reduce the founders' ownership further, possibly down to the 25 percent mark. At this point key founders will often begin drawing mid-range salaries and bonuses.[5]

- *Series C financing*: There is nearly always a need for outside executives at this stage. Perhaps the founders were excellent technologists and have developed the product through some initial customer trials or contracts, and perhaps the company is transitioning from a development stage to an execution-stage company. At this point certain founders may be asked to step aside for outside experts or other ''proven commodities'' that the outside investors hand-select, which may include a new CEO, a VP of sales (a pivotal figure in any enterprise making the transition to a sale-oriented company), a CFO and a VP of Marketing or VP of Engineering. If the company were replacing its entire founding team with new executives, the executives' equity compensation as a group would often be in the same neighborhood as the aggregate equity ownership of the founders after the Series B financing.

- *Series D financing and beyond*: As the company matures beyond the tumultuous early rounds and the risks in the company are lessened, the company would need to offer less equity to attract skilled managers. If,

[4] However, usually the founders' ownership stakes are worth more at each financing even though they own less of the company. This is a result of the value of the company increasing faster than the founders' ownership positions are declining. In a simplified example, at formation the founders own 100 percent of a company worth perhaps only a few thousand dollars. After the first financing, the founders may own 40 percent of a company (i.e., down from their 100 percent) worth $3 million. Thus, the founder stake has increased in value to $1.2 million although their total ownership has declined to 40 percent. The quintessential outside investment sales pitch is to convince founders that owning a small piece of something large is better than owning a large piece of something small.

[5] Despite their dwindling ownership as a portion of the company's total equity, the founders' decreased ownership will likely represent substantially more value that their pre-round ownership, assuming that the Series B financing was an ''up-round.''

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however, the company were in distress, the negotiation might center on how much the company once again resembles a start-up enterprise, and the equity compensation might reflect those substantial risks, resulting in more founder-like equity compensation for outside executives.

Because there is little public reporting of the compensation in the private-company universe, executive compensation data can be difficult to ascertain and to verify. While the ultimate form and amount of compensation should always boil down to the specific behavior the company is trying to incentivize in its workforce, professional compensation consulting firms often determine market standards through extensive surveys that capture a number of factors, including a company's region, industry, peer group, growth prospects, stage of development, and current financial and operational performance. For example, Advanced-HR, Inc. quantifies the above stages both in terms of executive cash compensation and equity apportionment in its annual venture capital executive compensation survey, which collected data from 1,568 private, venture-backed companies in 2016.[6]

### B. Board Members

Generally, only independent, outside board members of an emerging company receive compensation for serving as board members. The founders or executives of the company (the "inside directors"), and the representatives of the investors ("investor representatives") typically do not receive any compensation for their service as directors, although they often receive reimbursement of expenses incurred for attending meetings.

Upon joining the company, independent outside directors are typically awarded an equity or equity-based award with a vesting condition requiring their continued service on the board for periods ranging from one to four years. At each re-election to the Board, independent outside directors may be awarded an annual grant one-fourth to one-third the size of the initial grant, which generally vests ratably over each re-election term. Option-based compensation is substantially less common for directors of large companies.[7]

### C. Advisors

Some companies (often those in the technology space) retain individual board advisor or assemble an entire board of advisors who have specialized expertise that can benefit the company. Advisors typically sign a modified form of consultant agreement that allows them to consult with other companies, and are sometimes paid a cash fee along with an equity option grant. The cash fee is usually paid per meeting, and the agreement usually commits the advisor to spending four half-day to full-day sessions with the company per year. The cash fee may range in the thousands of dollars per meeting, and reimbursement of expenses incurred in traveling to the meeting is often provided. The equity option grant is usually at the low end of the director grants, with lower-level advisors receiving grants at one-half that level.

Advisors are typically independent contractors, and arrangements between companies and independent contractors who are not providing "management services" are generally exempt from Section 409A if the contractor provides "significant" services (other than as a member of the board of directors of a corporation or a similar position with respect to an entity that is not a corporation) in the same trade or business to two or more independent parties.[8] Whether a service provider provides significant services depends on the facts and circumstances of each case, but the regulations provide as a safe harbor that a service provider who provides services to two or more service recipients to which the service provider is not related and that are not related to one another is deemed to be providing significant services to two or more of such service recipients for a given taxable year if the revenues generated from the services provided to any service recipient or group of related service recipients during such taxable year do not exceed 70 percent of the total revenue generated by the service provider from the trade or business of providing such services.[9]

## IV. Components and Forms of Executive Compensation

Emerging companies typically do not have (or need) advanced compensation or benefits plans, programs or arrangements. Capital is the fuel that drives an emerging company's growth, and unnecessarily sophisticated (at that stage) compensation arrangements can drain capital and distract executives, impeding growth-producing business initiatives. Accordingly, the emerging enterprise will usually offer its employees a simple salary and annual bonus arrangement with additional incentive compensation in the form of time-based and/or performance-based restricted stock (for corporations), restricted partnership interests or membership units (for partnerships or limited liability companies), restricted share units or options.[10] This chapter is tailored accordingly.[11]

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[6] Advanced-HR, Venture Capital Executive Compensation Survey 2016, https://www.advanced-hr.com/wp-content/uploads/2016/10/2016%20VC%20Executive%20Compensation%20Trend%20Report.pdf.

[7] See, e.g., Steven Hall & Partners, 2015 Director Compensation Study at 12, http://www.shallpartners.com/wp-content/uploads/2015/09/SHP-2015-Director-Compensation-Study.pdf (finding that among the top 200 companies by revenue in fiscal 2014, outside director equity/equity-based compensation nearly always took the form of full-value awards (92 percent), followed by a mix of full value awards and options (6 percent), followed by options alone (2 percent), with options only slightly more common among companies included in the S&P SmallCap 600® (81 percent, 10 percent and 9 percent, respectively)).

[8] Treas. Reg. § 1.409A-1(f)(2) . For a detailed discussion of Section 409A, see the chapter Nonqualified Deferred Compensation Plans . For a comprehensive Section 409A resource tool, see Olshan, R. & Schohn, E.F., et al., SECTION 409A HANDBOOK (2d ed., Bloomberg BNA 2016).

[9] Treas. Reg. § 1.409A-1(f)(2)(iii) .

[10] Not to be confused with restricted stock or restricted units (which both represent the grant of actual company equity, subject to restrictions) restricted share units (which may also be called restricted stock units in the case of corporations) are equity-based contractual rights the value of which is determined by the value of the company's equity (and which may be settled with either company equity or other property, such as cash).

[11] More advanced compensation and benefits plans are typically reserved for larger operations and are outside the scope of this chapter. For example, pension plans (with the arguable exception of 401(k) plans), supplemental executive retirement plans (SERPs), alongside other cash-based retirement or deferred compensation arrangements, are often

### A. Salary

The most basic form of compensation in a start-up enterprise, salary provides executives with stable, reliable income. Salary can represent a major draw on a start-up's often limited liquid resources as the company grows, particularly if left unchecked (bad for the company), conveys no share of the profits (''upside'') to the recipient (bad for the recipient) and fails to substantially further the cause of shareholder-executive alignment of interests beyond the fact that an unsuccessful start-up and its cash are soon parted (bad for everybody).

For the reasons above, salary typically represents a smaller fraction of start-up executives' compensation packages, the remainder of which comprises incentive compensation in one form or another. Incentive compensation arrangements often reduce a start-up's monthly spend (thereby extending a start-up's ''runway,'' or time until insolvency, assuming revenue and expenses remain constant) as well as aligning executives' interests in strong company performance to those of shareholders—a big plus for outside investors.[12]

### B. Bonus Plans

A start-up may draw from a broad menu of bonus plans, from garden variety annual cash bonus plans to last-ditch efforts to keep executives from departing during troubled periods. Start-ups also frequently request outside counsel to custom-build bonus plans unique to their company's space and goals. A summary of the most frequent types of bonus plans is presented below.

#### 1. Short-Term Incentive Plan

A short-term incentive plan (also known as an annual bonus plan or STIP) is any bonus plan with a performance cycle up to one year. Written STIPs tend to fall next to salary on the compensation spectrum. Written STIPs range in complexity from just one sentence within an employment agreement or company policy to stand-alone plans running in the dozens of pages and containing explicit rules for participation eligibility, company discretion to adjust awards, potential performance criteria from which the company may draw from year to year, changes in control, employment terminations and more.[13]

#### 2. Long-Term Incentive Plan

A long-term incentive plan (also known as an LTIP) is any bonus plan with a performance cycle longer than one year. LTIPs tend to be equity or equity-based, the former meaning actual company equity is awarded based on performance and the latter meaning cash or other non-equity property is disbursed based on company performance during the performance period and the value of company equity at such time. For example, under an equity-based LTIP an executive might receive 10,000 LTIP units at the commencement of the performance cycle, each LTIP unit equal in value to one share of company equity (corporate shares, partnership interests or membership units, as applicable), and if the company's value increases from $5 per share to $10 per share during the performance cycle and target performance is achieved, such that the award pays out 100 percent of target, the executive would receive $100,000, even though the underlying LTIP units were only worth $50,000 at grant. Through such an arrangement the company would align the executive's and shareholders' interests without the company actually issuing equity to the executive.

#### 3. Event-Based Bonus Plans

''Event-based bonus plan'' is a term of art referring to any bonus plan with payment contingent on a non-cyclical event. This plan category comprises, for example, Change in Control Bonus Plans, Transaction Bonus Plans, Liquidity Event Bonus Plans, Change in Control Retention Plans, etc. These plans are often designed and implemented to incentivize employees to build the company for an exit or add a layer of stability during a tumultuous period (for example, if rumors of an impending sale or layoffs spook a company's workforce). Depending on the payment trigger, these plans could require little or no cost to implement. Five common plan types and an example payment trigger for each is listed below by way of example:

- *Change in Control Bonus Plan*: ''if Participant remains in continuous employment with the Company through a Change in Control,[14] Participant will receive [$500,000] [an amount equal to 0.05 percent of the net consideration received in such Change in Control over $500 million] [the greater of $500,000 or an amount equal to 0.05 percent of the net consideration received in such Change in Control over $500 million].''

- *Transaction Bonus Plan*: ''if Participant remains in continuous employment with the Company through a

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viewed as unnecessary distractions when the workforce is small and shares a near-singular purpose (e.g., grow the company for sale or bring a specific technology to market) and do not become relevant until the company's workforce grows into a multi-tiered, complex structure comprising various departments and divisions, often with entirely distinct goals.

[12] For these reasons it is increasingly common for CEOs, who often see massive upside potential in their ventures, to accept a $1 salary in exchange for substantial incentive-based compensation.

[13] Bare-bones STIP language might be structured as follows:

> During the Term, the Executive shall be eligible to participate in the Company's Short-Term Incentive Plan (the ''STIP'') with a target incentive opportunity of [25 to 100] percent of the Executive's Base Salary. Actual payment under the STIP, if any, will be determined in the Company's sole discretion, including without limitation to the degree of achievement of Company objectives and the Executive's individual performance and contribution, and may be more or less than the communicated target and is contingent upon the Executive's status as an employee in good standing as of the applicable STIP payout date (except if the Executive's employment is terminated by the Company without Cause [or by the Executive for Good Reason], in which case such opportunity shall be prorated based on the Executive's period of service). Payment of the bonus, if any, shall be no later than March 15 of the year following the year to which the performance relates.

[14] The definition of ''Change in Control'' can vary from agreement to agreement but well-drafted provisions often include a savings clause such as ''notwithstanding anything to the contrary, to the extent necessary to avoid the imposition of additional tax or penalties under Section 409A, a Change in Control shall not be deemed to have occurred if the Change in Control event does not constitute a change in ownership or effective control of the Company or a change in ownership of a substantial portion of the assets of the Company within the meaning of Section 409A, including Treasury Regulation Section 1.409A-3(i)(5)(i) .''

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Change in Control involving [a specific buyer], Participant will receive a one-time bonus equal to $400,000 (for each of the CEO and CFO), $300,000 (for each EVP-level officer), or $200,000 (for each SVP- or VP-level officer).''

- *Liquidity Event Bonus Plan*: ''if Participant remains in continuous employment with the Company through (a) a Change in Control, (b) an initial public offering of the company worth at least $400 million, after which at least 25 percent of the company's equity is actively traded on a public securities market, or (c) a liquidation of the company, Participant will receive $500,000.''

- *Change in Control Retention Plan*: ''if Participant remains in continuous employment with the Company for at least 12 months following a Change in Control or is terminated by an acquiror without Cause[15] or resigns for Good Reason[16] within 12 months following a Change in Control, Participant will receive $500,000.''

- *Retention Plan*: ''if Participant remains in continuous employment with the Company for at least 12 months following the date hereof, or is terminated by the Company without Cause prior to such time, Participant will receive $500,000.''

While most event-based bonus plans are unfunded (for tax and business reasons), start-ups should be wary of doling out participation in such plans too generously. Buyers routinely take such plans into account in appraising the enterprise value of the company, which means such plans often detract from shareholder value upon exit.

#### 4. Management Bonus Plans

Management bonus plans (or MBOs) are typically reserved for start-ups experiencing difficulty retaining management or attracting sufficient capital to carry the company to its next milestone, usually a sale of the company or validation of the company's products through a major customer sale, license, or collaboration. MBOs are often implemented by the company's major investors' injection of additional capital into the company to motivate management to remain. A ''turnaround expert'' may join the company (and participate in the management bonus plan) at this stage.

The investment that keeps the company alive—in venture capital parlance, ''keeps the company on life support''—has many varieties, but one central feature is that due to the heightened risk in the company and the substantial uncertainty about getting any return on the investment being made, the investors generally command, as part of their return on their last ditch investment, a substantial portion of the possible increase in value of the company. Accordingly, because the investors require a substantial return on their investment in order to act as rescuers of the troubled company, there is little upside left for the equity holders, including management. For example, some investments are structured as bridge loans by which the investors loan funds to the company for operations to tide the company over until it can be sold. The investors may require a return of double or triple their loan principal in return for taking the colossal risk that zero capital will be returned, although some companies subsequently become hugely successful. Because such arrangements often reduce the company's expected sale value to be realized by ordinary equity-holders, including the management and employees, in these situations it is common for the company to implement a special bonus plan that provides a certain percentage of the total acquisition value of the company to such groups.

By way of further example, an MBO plan might provide that for sale values of the company up to $20 million, the management and employee bonus pool will consist of 10 percent of the gross sale proceeds so that the company's management and employees will share $2 million if the company is sold for $20 million. This is a simplified example. Many of these plans use a formula that begins to reduce the bonus payments as company equity and options begin to come into some value so that at very high sale values, the bonus plan may not provide any payment at all because the equity indeed turned out to have value after all. These often complex situations do not lend well to generalization except to say that management (the company's executives) usually participate in these bonus plans substantially, and these plans represent another form of executive compensation when the company is nearly out (or out) of runway.

### C. Equity and Equity-Based Awards

As a company passes initial growth milestones, its benefits offerings typically expand to include a modest array of health and welfare benefits (commonly medical, dental, vision, disability and life insurance). However, the vital compensation arrangements in the emerging company continue to center around equity or equity-based awards, and until a company is well developed it is likely to put far greater consideration into designing, negotiating, updating and maintaining these arrangements than into general health and welfare benefits, for which ''off the shelf'' plan products often suffice. Negotiations over structuring the company's equity arrangements typically center on vesting, and in particular the events that will trigger an acceleration of vesting. For administrative, tax and securities law reasons, equity and equity-based awards issued to company employees and/or service providers are nearly always issued pursuant to written LTIPs.[17]

[15] The definition of ''Cause'' is highly variable but often includes some combination of the following elements on behalf of the service provider, typically combined with a ''cure'' period: (i) failure to perform assigned duties; (ii) engaging in dishonesty, fraud or misrepresentation; (iii) acting unlawfully; (iv) breaching an agreement with the company; or (v) conviction or pleading nolo contendere to any crime or committing any act of moral turpitude.

[16] The definition of ''Good Reason'' is highly variable but often includes some combination of the following elements on behalf of the company, typically combined with a ''cure'' period: (i) a material adverse change in the nature or scope of the service provider's duties or responsibilities; (ii) a reduction in compensation (perhaps with an exception for limited across-the-board reductions); (iii) a relocation of the service provider's work location greater than 50 miles; (iv) breaching an agreement with the service provider; or (v) requiring the service provider to act unlawfully.

[17] For example, California Code of Regulations Section 260.140.41 establishes the requirements for a stock option plan to constitute a ''compensatory stock option plan'' under which company equity may be issued in compliance with California securities laws.

### 1. Equity

As discussed in the introduction to this chapter, in general terms equity takes the form of shares of stock (for corporations), partnership interests (for partnerships) or membership units (for limited liability companies), depending on the enterprise's entity classification. The purchase of equity often makes the most sense for founders because the company has little or no built-in value at its initial stage. Founders typically purchase ''founder equity'' by contributing cash, other property (often intellectual property) or services to the company before the company has any built-in value. Accordingly, the founders purchase their equity at a very low purchase price, often in the tenths of a penny per share. Usually the founders pay cash, which provides the initial capital of several thousand dollars for the company's initial activities. During a start-up's later stages (i.e., when the company has built-in value), outside executives may often purchase equity as well, albeit they almost always either pay more per share than the founders or, if the equity is issued in exchange for the performance of services, pay relatively higher taxes on the issuance.

The purchase of equity outright establishes a purchase date for the commencement of a capital gain holding period.[18] If the company is acquired or the equity sold at any time after one year from the date of purchase, the executive would be taxed on the gain from the sale of the equity at the favorable long-term capital gain rate.[19] In addition, if the company is a corporation and the stock is ''qualified small business stock'' as defined in Section 1202 and if the executive has held the stock for five years, the federal tax rate is cut in half by virtue of the up-to 50 percent gain exclusion rule of Section 1202(a).[20]

#### a. Purchasing Equity with Cash

Founders typically purchase their equity through the investment of a company's initial capital, and there are many advantages to the incoming executive in simply purchasing his or her equity. Non-founders are sometimes less enthusiastic about investing their money as well as their time into the success of the business, preferring diversification over a potential over-investment in one asset, which could bring about a significant loss of wealth if the enterprise is not successful.[21]

#### b. Purchasing Equity with Promissory Note

An alternative that is less effective at solving the executive's diversification problem is to allow the executive to purchase his or her equity in whole or in part with a promissory note. The main benefit of this structure is that if properly arranged, the executive owns the equity, and if the executive sells the equity more than one year after the purchase date, the executive will pay capital gain rates on the profit from the sale of the equity, and will repay the note amount from the gains from the sale of the equity. This arrangement has four major potential pitfalls:

- *Substantially Full Recourse*. In order for the promissory note to be respected as actual consideration paid for the purchase of the equity, the Code requires that the note must be ''substantially full recourse.''[22] In other words, the company must be able to proceed against any assets of the executive in order to secure payment on the note, not just against the equity that was purchased. Thus, if the company declares bankruptcy, a creditor or the bankruptcy trustee may pursue payment on the note from the executive's personal assets in the event of default, even though the equity at the time of the bankruptcy would be worthless. If the note is considered less than substantially full recourse, then in addition to the consequences described below the Internal Revenue Service may recharacterize the arrangement as an incorrectly reported (i.e., disguised) option to acquire company equity, with the actual purchase occurring when the note is paid.[23]
- *Repayment upon IPO*. If the executive were a director or executive officer (or equivalent thereof), then the loan would need to be repaid upon an IPO.[24]
- *Cancellation of Debt Income*. If the company forgives the loan, the balance forgiven would generally constitute taxable ordinary income to the executive.[25]
- *Adequate Interest Rate*. The note must bear interest at a rate that is at least the applicable federal rate, depending in part on the loan's duration, or a portion of the principal to be repaid will be deemed interest under the original issue discount rules.[26]

### 2. Restricted Equity

#### a. General Principles

Founders often subject their equity to a time-based vesting restriction by mutual agreement because each founder has an interest in preventing the other found-

[18] Code § 1223 .

[19] Code § 1(h) . The taxation calculation's complexity increases in the case of partnership and limited liability companies (except those that elect to be taxed as corporations) due to pass-through taxation principles.

[20] Code § 1202. There are other favorable provisions in § 1202 allowing for the deferral of and for the rollover of Section 1202 gain into other small business issuers within 60 days of sale. Code § 1045 .

[21] A classic example of this nondiversification in the public company context was the 401(k) assets of the Enron employees being invested in Enron stock. When Enron declared bankruptcy, those employees—many of whom later lost their jobs—lost substantial wealth through the decline in value of their 401(k) accounts, which held worthless Enron stock. See Millon, David, Worker Ownership Through 401(k) Retirement Plans: Enron's Cautionary Tale, St. John's L. Rev. , Fall 2002.

[22] Treas. Reg. § 1.83-3(a)(1) . See also Treas. Reg. § 1.83-3(a)(7) , Example (2). For a detailed discussion of nonrecourse debt, see the chapter Using Equity to Compensate Executives: Part I - Taxation , at ''Nonrecourse Debt .''

[23] If the note were paid upon sale of the underlying equity, as is often the case, the deemed holding period would be minimal and any gain would be taxed as ordinary income, possibly undermining the holder's tax plan. An example makes the IRS's concern clear: an executive purchases stock in exchange for a fully non-recourse promissory note, on which the executive pledges the stock. If the stock value increases, the executive repays the note and enjoys the early holding period. If the stock value decreases, the executive walks away from the loan entirely, having lost nothing, resulting in the company recovering the stock and no further consequences to the executive. The IRS would treat such an arrangement as a disguised stock option because the executive did not bear any of the burdens of ownership due to his or her walk-away right.

[24] Section 13(k) of the Securities Exchange Act of 1934 , as added by Section 402(a) of the Sarbanes-Oxley Act of 2002 .

[25] Code § 61(a)(12) ; Rev. Rul. 2004-37 (Feb. 25, 2004); Treas. Reg. § 1.83-4(c) .

[26] Code § § 1274 , 7872 (however, loans under $10,000 are generally exempt from this treatment pursuant to Code § 7872(c)(3)(A) ).


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ers from making an initial contribution and then sitting on the sidelines while the other founders work to build up the company.[27] Even if the founders were all sufficiently trusting of each other and imposed no vesting restrictions (an often ill-advised decision), a subsequent outside investor would likely require that at least some of the founders' equity be made subject to vesting as a condition to such investment.

In this context, vesting refers to the right of the company to repurchase the equity from the holder if the holder's employment or service with the company ceases, which right lapses over time as the employee or consultant continues to work for the company.[28]

[27] Vesting concerns typically do not apply to founders who are akin to ''silent investors'' by mutual agreement of the parties; such investors' sole purpose is to invest and sit on the sidelines.

[28] Code § 83 . In an equity purchase agreement, the equity (in this case, stock) vesting provision might be structured as follows:

> In the event the Purchaser ceases to be an employee, consultant, advisor, officer or director of the Company (a ''Service Provider'') for any or no reason, including, without limitation, by reason of Purchaser's death or disability (as defined in Section 22(e)(3) of the Internal Revenue Code of 1986, as amended (the ''Code'') ''Disability''), resignation or involuntary termination, the Company shall, from such time (as determined by the Company in its discretion), have the right, but not the obligation (the ''Repurchase Option''), for a period of [90] days from the date Purchaser ceases to be a Service Provider, to repurchase any Shares which have not yet been released from the Repurchase Option (the ''Unreleased Shares)'' at a price per share equal to the lesser of (x) the fair market value of the shares at the time the Repurchase Option is exercised, as determined by the Company's board of directors and (y) the Purchase Price (the ''Repurchase Price''). The Repurchase Option shall be exercised by the Company by delivering written notice to the Purchaser or, in the event of the Purchaser's death, the Purchaser's executor and, at the Company's option, (i) by delivering to the Purchaser or the Purchaser's executor a check in the amount of the aggregate Repurchase Price, or (ii) by canceling an amount of the Purchaser's indebtedness to the Company equal to the aggregate Repurchase Price, or (iii) by a combination of (i) and (ii) such that the combined payment and cancellation of indebtedness equals the aggregate Repurchase Price. Upon delivery of such notice and the payment of the aggregate Repurchase Price, the Company shall become the legal and beneficial owner of the Unreleased Shares being repurchased and all rights and interests therein or relating thereto, and the Company shall have the right to retain and transfer to its own name the number of Unreleased Shares being repurchased by the Company. The Company in its sole discretion may assign all or part of the Repurchase Option to one or more employees, officers, directors or stockholders of the Company or other persons or organizations. So long as the Purchaser's continuous status as a Service Provider has not yet terminated in each such instance, [25 percent] of the total number of Shares shall be released from the Repurchase Option on the [one-year] anniversary of this Agreement, and an additional [1⁄48 th] of the total number of Shares shall be released from the Repurchase Option on the corresponding day of each month thereafter (or if there is no corresponding day in any such month, on the last day of such month), until all Shares have been released on the [fourth] anniversary of this Agreement.

#### b. Section 83(b) Elections

Under the default tax rules, when a company issues restricted equity to any person, whether in consideration for cash (i.e., a purchase) or in consideration for the performance of services, the equity-holder will recognize ordinary income at each date that the equity vests (often over 36 months following a 25 percent vesting cliff at the one-year mark), and the measurement of that compensation is the difference between the value of the equity that vested in that period and the price paid, if any, for the equity that vested in that period. As such, the equity-holder will ordinarily recognize income as the equity vests even though the equity has not been sold (so-called phantom income). If the equity is worth much more at vesting than at grant, the amount of income to be recognized upon such vesting could be significant.

The way out of this Kafkaesque taxation scheme is for the equity-holder to file a tax election under Section 83(b), known as an ''83(b) election.''[29] An 83(b) election informs the IRS that the purchaser is electing to pay the tax currently on the difference between the price paid for the equity and the value of the equity if all of the vesting restrictions were removed. In other words, even though the IRS would still consider the equity subject to a ''substantial risk of forfeiture'' due to its vesting restriction, the 83(b) election allows the purchaser to ''elect'' to pay the tax on a current basis based on the difference between the price paid for the shares currently subject to the substantial risk of forfeiture, and the value of the shares if such substantial risk of forfeiture were removed.[30]

83(b) elections typically arise in three situations:

■ *Restricted Equity Purchased at Fair Market Value*. If an executive purchases restricted equity at fair market value, it is generally advisable that the executive make an 83(b) election because, there being no gap between the value of the equity and the price paid, the resulting tax liability from such election would be $0, with no additional liability when the equity later vests. In the absence of an 83(b) election the holder could face a potentially seriously adverse tax consequence of having to recognize ordinary income at each period when the equity vests under the purchase agreement.

■ *Early Exercise*. If an executive exercises an ''early exercise'' option during the early exercise period, it is generally advisable for the executive to make an 83(b) election, which would both accelerate (and lower, if the shares acquired upon exercise subsequently appreciate in value prior to vesting) the tax event normally incurred in connection with vesting and begin the holding period of the resulting equity for capital gain purposes.[31] If the exercise occurs close in time to the op-

[29] Code § 83(b). Revenue Procedure 2012-29 contains a model election form that may be used to make the § 83(b) election.

[30] Code § 83. For a discussion of advanced Section 83 issues, see the chapter Using Equity to Compensate Executives: Part I - Taxation , at ''Advanced Code § 83 Issues .''

[31] Note, however, that ''$100,000 Rule,'' discussed below, applies whether an early exercise option is actually exercised or not in the first year or not, and can thus undermine the benefit of the early exercise provision. Code § 422(d)(1) . In contrast to an early exercise option, a market-standard vesting op-

tion grant then, like the example above, the tax cost of such election could be as little as $0, with no additional liability when the equity later vests. However, when a value difference exists such that tax is due in connection with the 83(b) election, and the equity subsequently declines in value before its vesting event, the Code contains no provision allowing a holder to receive a refund for the earlier tax paid.

■ *Restricted Equity in Exchange for Services*. If an executive receives restricted equity in exchange for the performance of services, whether to make an 83(b) election in this context may be a closer call because it would accelerate a tax event on the difference between the fair market value of the award at grant versus the purchase price, if any. As in the second situation above, if the holder makes an 83(b) election and the restricted equity value declines prior to vesting, no refund may be received.

In all 83(b) situations above the holder must file an 83(b) election within 30 days of the date the holder is transferred restricted shares, and there is no remedy available in the Code or regulations for a late filing.[32] Accordingly, a late 83(b) election is in theory as good as not filing one at all. No additional 83(b) election needs be filed in the case of a ''revesting'' that an outside investor may require.[33] Some holders prefer to file a ''protective'' 83(b) election in this circumstance anyway, which is at worst a harmless exercise.

Section 83(b) elections can only be made with respect to actual property (e.g., shares of stock). Thus, 83(b) elections cannot be made with regard to any option, including ''early exercise'' options that have not yet been exercised (though at exercise an 83(b) election could be made on the resulting restricted shares issued as a result of the exercise). The same analysis applies to restricted share units, phantom stock awards and share appreciation rights, all of which are mere contracts for the contingent future provision of equity or other property.[34]

### 3. Options to Acquire Equity

Purchasing equity has downsides, particularly for nonfounders. If the equity remains illiquid or its value declines after purchase, then the purchase would represent an actual loss. A common alternative is to grant the executive an option to acquire equity, which provides for greater tax deferment opportunities and downside value protection. An option is the right to acquire a fixed number of shares at a fixed price for a fixed period of time.[35] An option allows the executive to control the right to purchase shares without having to immediately commit personal capital to the purchase. The tax benefit to an option is that there is no income deemed received for tax purposes on the date of grant of the option, provided that the option is granted at fair market value on the date of grant.[36]

Options are commonly granted subject to a vesting schedule. Vesting may be time-based and/or event-based (i.e., dependent on the occurrence or non-occurrence of any condition, such as an IPO). Furthermore, certain options are granted as ''early exercise'' options. These options may be exercised at vesting for unrestricted equity or prior to vesting for restricted shares that would generally pick up the remaining portion of the option vesting period in the form of a company repurchase right. As described above, a holder may make an 83(b) election within 30 days of such early exercise.

In the United States there are two forms of corporate stock options. One is a tax-advantaged instrument satisfying certain conditions specified in the Code and known as an incentive stock option (also known as a statutory stock option or ISO), and the other is an option that does not meet such conditions and is known as a nonqualified stock option (also known as a nonstatutory stock option or NSO).[37] Only corporations may issue incentive stock options—partnership and limited liability company equity options are always treated like NSOs (assuming the issuer has not elected to be taxed as a corporation).

#### a. Incentive Stock Option

##### i. Grant

Although the ISO rules contain many nuances, the main requirements for the creation and grant of an ISO are:

(1) the plan pursuant to which the ISOs are granted must have board approval and, within 12 months thereafter, shareholder approval;[38]

(2) ISOs must be granted with an exercise price that is no less than fair market value on the date of grant, and for an optionee owning more than 10 percent of the voting power of a company, at no less than 110 percent of fair market value on the date of grant;[39]

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tion (i.e., four-year vesting with a 25 percent ''cliff'' on the first anniversary) may not face this $100,000 Rule problem because only one-quarter of the total shares subject to the option would vest and be exercisable in any one year.

[32] Treas. Reg. § 1.83-2(b) . There are many sad instances of 83(b) elections not being filed on time to the dismay of the taxpayer and to the potential liability of the service provider failing to make the filing timely. A copy of the 83(b) election is no longer required to be attached to a filer's tax return for the year in which the property was transferred. T.D. 9779 , 81 FR 48708 (July 26, 2016) (revoking in part Rev. Proc. 2012–29 , effective January 1, 2016, with a transition period for transfers occurring in 2015).

[33] Rev. Rul. 2007-49 (''There is not a transfer of substantially nonvested stock subject to § 83 where restrictions imposed on substantially vested stock cause the substantially vested stock to become substantially nonvested.''). However, a transfer would be deemed to occur if a service provider exchanged substantially vested stock for substantially nonvested stock in either a reorganization described in Code § 368(a) or a taxable stock acquisition. *Id.*

[34] Stock options, phantom stock awards and stock appreciation rights are all discussed below.

[35] See below for a discussion of the differences between incentive stock options and nonstatutory stock options. For a discussion of advanced option issues, see the chapter Using Equity to Compensate Executives: Part I - Taxation , at ''Advanced Option Issues .''

[36] But see below regarding Code § 409A, which imposes additional taxes on discounted stock options, which if discounted would not be ISOs.

[37] Code § 422 et seq.

[38] Code § 422(b)(1). In addition, the plan must specify the total number of shares subject to the plan, and must specify the eligible class of employees and/or consultants who may be granted options under the plan.

[39] Code § 422(b)(4) and (c)(5). The determination of fair market value is discussed below in ''A Common Theme: Fair Market Valuation .'' Granting at below fair market value on the date of grant is one of the main issues surrounding the public-company ''option-backdating'' scandal.


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(3) the plan and each option agreement must have a duration of no more than 10 years, or for an optionee owning more than 10 percent of the voting power of a company, more than five years;[40] and

(4) ISOs can only be granted to employees and are nontransferable.[41]

### ii. Exercise

The exercise of an ISO generally does not cause any income to be recognized by the optionee (however, see the alternative minimum tax discussion below). Thus, even if there is a ''spread'' (i.e., a difference between fair market value of the stock acquired through exercise on such date and the option's aggregate exercise price, such that the option is considered ''in the money''), the exercise of that option does not trigger any income to be recognized, and the company for which the option is exercised receives no compensation-related tax deduction, unless the stock is sold in a ''disqualifying disposition.''[42] Note, however, that under the ''$100,000 Rule,'' if an ISO becomes exercisable for more than $100,000 of stock (total shares multiplied by exercise price) in any one year, then any amount in excess of $100,000 will be treated as NSO, rather than ISO, stock.[43] All else being equal, executives would prefer to have an ISO rather than an NSO because of tax deferment and potential capital gain treatment on the spread, although in actual experience this tax advantage is very rarely realized due to the disqualifying disposition rule discussed below.

One complication for an ISO-holding executive is that upon exercise the spread that is not taxed as ordinary income must be recognized for purposes of calculating the alternative minimum tax (AMT). Thus, although the optionee will pay no regular tax when he or she exercises an ISO, the optionee must include in his or her alternative minimum taxable income (AMTI) the option spread, which may cause the optionee to have to pay AMT in that tax year.[44] Accordingly, even though there is ostensibly no tax on exercise of an ISO, the exercise may cause the executive to be subject to the AMT, which might defeat, at least in part, the benefit of having an ISO. In addition, even if the stock acquired on exercise declines in value after exercise, the spread included in AMTI is the amount recognized on exercise, not the amount determined at some later time.[45] This was an unfortunate occurrence for many employees who exercised stock options during the Internet bubble years of the late 1990s or prior to the 2007–2014 financial crisis, and who held their stock only to watch it decline in value.[46]

### iii. Sale and Disqualifying Disposition

To maintain the favorable tax treatment of the ISO exercise, the optionee must hold the stock acquired upon exercise for the longer of two years from the date of grant of the option and one year from the date of exercise of the option. This summary assumes a profitable sale for simplicity.

- *Qualifying Disposition*. If the above conditions are met then the disposition will be deemed a ''qualifying disposition'' and the holder will receive (a) capital gain treatment on the difference between the option's exercise price and the stock's fair market at exercise, and (b) capital gain treatment on the difference between the stock's fair market value when the option was exercised and the sale price.

- *Disqualifying Disposition*. If the above conditions are not met, then the disposition will be deemed a ''disqualifying disposition'' and the holder will receive (a) ordinary income treatment on the difference between the option's exercise price and the stock's fair market at exercise, which would adjust the stock's tax basis accordingly (and the company would get a compensation-related tax deduction but, in a minor twist, such income would not be considered ''wages'' for purposes of FICA, FUTA or federal income tax withholding),[47] and (b) capital gain treatment on the between the stock's fair market value when the option was exercised and the sale price—which, if the stock were held for less than one year, would be short-term capital gain (treated akin to ordinary income).

The vast majority of ISOs that are disqualified fail the requirement to hold the resulting stock for one year between exercise and sale. The various exercise-and-sale situations coalesce into two major events: an IPO and a change in control.

- *IPO*. For many optionees, an IPO (or any comparable situation in which the underlying stock becomes liquid, including the expiration of a post-IPO lock-up period)[48] represents the culmination of years of work and relative illiquidity,[49] and a workforce's desire to ''take profit'' by the exercise and immediate sale of options is often so strong that companies set up same-day

[40] Code § 422(b)(2) and (3); § 422(c)(5).

[41] Code § 422(b)(1) and (5).

[42] See below for discussion on disqualifying disposition.

[43] Code § 422(d)(1).

[44] Code § 56(b)(3) .

[45] However, if the optionee disposes of the stock in same tax year as exercise, the regular tax and AMT treatments are the same; namely, the amount includible as taxable income is the amount realized on disposition of the stock minus the adjusted basis. Code §§ 422(c)(2) and 56(b)(3).

[46] For more detail on this unfortunate phenomenon, see Lipman, Francine, ''Incentive Stock Options and the Alternative Minimum Tax: The Worst of Times,'' 39 Harv. J. on Legis. 337 (2002), available at http://www.law.harvard.edu/students/orgs/jol/vol39_2/lipman.pdf . See also *Speltz v. Commissioner* , Docket No. 15382-03L, 124 T.C. 165 , 5 EXC 9 (March 23, 2005), *aff'd on other grounds* , 454 F.3d 782 , 5 EXC 10 (8th Cir. 2006). Congress provided some relief for taxpayers in Speltz's position by allowing for an increased alternative minimum tax credit and making the additional credit amount refundable, but this only partially lessened the severity of the AMT in these situations.

[47] Code §§ 421(b) (income tax), 3121(a)(22) (FICA), 3306(b)(19) (FUTA).

[48] An IPO lock-up is an agreement between company shareholders and underwriters by which shareholders agree not to sell their stock that they acquired prior to the company's IPO until (most commonly) 180 days after the company's IPO. The company's underwriters near-uniformly request these agreements to control the amount of stock that comes to market after the company's IPO and thereby avoid downward pressure on the market price of the company's stock. In many technology and life sciences companies, a form of lock-up is included in all pre-ISO stock purchase and option agreements.

[49] The increasing prevalence of so-called ''secondary markets'' (online platforms on which accredited investors buy and sell transferable private company stock), the expansion of ''crowd-funding'' securities laws in 2014 and the use of variable prepaid forward contracts may challenge the notion that start-up stock is illiquid.

exercise and sale programs to facilitate the process as rapidly as possible.[50]

■ *Change in Control*. In a sale of the enterprise, the deal parties will decide (or the applicable documents will determine) what happens to target company ISOs. In some cases the ISOs are cashed out, which is treated as a sale of ISOs in exchange for a compensation bonus subject to income tax, FICA and FUTA withholding.[51] Note that a different result is achieved if the optionee exercises his or her ISOs prior to the transaction—in that case the optionee's holding of the underlying stock would cause the resulting sale of that stock to constitute a disqualifying disposition, resulting in no income tax, FICA or FUTA withholding.

#### b. Nonstatutory Stock Option

##### i. Grant

Any option that does not by its terms purport to be an ISO or that does not meet the ISO grant conditions is considered an NSO at grant. In addition, as discussed above, an optionee can take (or fail to take) certain actions that can result in the recharacterization of an ISO into an NSO.[52] The optionee-favorable tax treatment of the ISO will be lost upon recharacterization into an NSO.[53]

##### ii. Exercise

The exercise of an NSO is an income recognition event (assuming the NSO is not underwater at exercise and the resulting equity is not considered subject to a ''substantial risk of forfeiture'' post-exercise).[54] In such a situation, the entire spread between fair market value of the shares being acquired on the date of exercise and the exercise price is considered ordinary income to the optionee, and is recognized as such on the exercise date (and subject to income tax, FICA and FUTA withholding), while the company-issuer (assuming the company is/was the employee's employer) receives a compensation-related tax deduction equal to the spread on the option. The tax basis of the equity acquired upon exercise of the NSO is increased to cover the portion of appreciation for which the holder pays tax upon exercise. All else being equal, companies generally prefer to issue an NSO than an ISO because of the potential to take a compensation-related tax deduction.

##### iii. Sale

This summary assumes a profitable sale for simplicity. When shares received in an NSO exercise are later sold, the tax treatment is similar to a disqualifying disposition of shares underlying an ISO. The holder will receive (a) no tax treatment on the difference between the option's exercise price and the equity's fair market at exercise, which was already realized at exercise, and (b) capital gain treatment on the difference between the equity's fair market value when the option was exercised and the sale price—which, if the equity were held for less than one year, would be taxed as short-term capital gain (i.e., treated akin to ordinary income).[55] Due to pass-through taxation principles that generally apply to partnerships and limited liability companies, the frequently changing tax basis of a partner or limited liability company member may complicate his or her tax position.

#### c. Section 409A and Options

In October 2004, Congress passed and President Bush signed into law the American Jobs Creation Act of 2004.[56] Among other matters, the Act added Section 409A to the Code. Section 409A implemented changes in the federal taxation of deferred compensation arrangements—what Section 409A refers to as ''nonqualified deferred compensation.'' In general, Section 409A provides that amounts deferred under such deferred compensation arrangements are includible in gross income on the later of when such amounts are deferred or when the amounts are no longer subject to a substantial risk of forfeiture, unless the arrangement is exempted from Section 409A.[57] Section 409A imposes an additional 20 percent excise tax on all noncompliant nonqualified deferred compensation, along with underpayment interest and penalties.[58]

All is not lost when an option fails to be exempt from Section 409A. Rather, like Section 409A's general application to nonqualified deferred compensation, a ''409A compliant'' option may also escape Section 409A's surtax provisions. Such an option would be limited in several regards, including on the timing discretion of any exercise (e.g., such an option might provide that it is automatically exercised upon vesting) to prevent what would be perceived as a subsequent deferral election under Section 409A. In practice, however, the vast majority of options are designed to be exempt from Section 409A. The necessary qualifications are discussed below.

##### i. Section 409A and ISOs

Section 409A exempts ISOs.[59] The ''catch,'' however, is that options intended to be ISOs but not granted at fair market value on the date of grant will be disqualified

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[50] Many of these programs are structured to allow the optionee to use proceeds from the sale to pay the exercise price, even though the exercise occurs prior to the sale. Most of these programs are set up through brokerage firms that essentially loan the exercise price to the optionee that day, execute the sale of the stock for the optionee, retain a commission or negotiated charge for the service, and then pay over the exercise price to the company from the proceeds of the sale. The optionee retains the remainder of the sale proceeds.

[51] Treas. Reg. § 1.83-7(a) . Note that in option cash-out payments to optionholders who are neither current nor former employees are not treated as compensatory. However, since employment is a condition to receiving an ISO, the non-employee situation does not arise in this context.

[52] See below on dispositions of the optioned stock and stock option modifications.

[53] Before prematurely lamenting the loss of favorable tax benefits upon conversion of an ISO to an NSO, it should be recognized that in specific situations well-advised optionees intentionally trigger such a recharacterization.

[54] Code § 83. An option is considered underwater when its exercise price equals or exceeds the value of the underlying equity.

[55] Although technically the sale of an NSO, the tax treatment upon a disqualifying disposition of an ISO is discussed above under ''Incentive Stock Option—Sale and Disqualifying Disposition .''

[56] Pub. L. No. 108-357 .

[57] Substantial risk of forfeiture, for Section 409A purposes, is defined in Treas. Reg. § 1.409A-1(d) .

[58] State level Section 409A excise taxes may also apply. For example, California imposes an additional 5 percent Section 409A excise tax, resulting in an aggregate 25 percent excise tax to California residents. See Cal. Rev. Tax Code § 17508.2.

[59] Treas. Reg. § 1.409A-1(b)(5)(ii).

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and become subject to Section 409A. Thus, failure of an intended ISO grant carries the risk that Section 409A will apply to the grant. Accordingly, it is imperative to ensure that an intended ISO meets all of the ISO requirements, particularly the requirement that the ISO be granted at fair market value on the date of grant.[60]

### ii. Section 409A and NSOs

An NSO is exempt from Section 409A if:[61]

(1) the NSO's underlying shares constitute ''service recipient stock'';[62]

(2) the NSO is subject to Code Section 83's general tax treatment;

(3) the NSO is granted with an exercise price at or above fair market value on the date of grant;

(4) the number of shares subject to the NSO is fixed on the grant date; and

(5) the NSO does not include any additional feature for the deferral of income other than deferral of recognition of income until the NSO is exercised.

### iii. A Common Theme: Granted at Fair Market Value

While hardly an issue for corporations whose stock is readily tradable on an established securities market,[63] an IRS challenge to a privately held company's determination of the fair market value of its equity on the date of grant of options is a direct threat that such options might be subject to Section 409A regardless of whether the option is an ISO or an NSO. Fortunately, the IRS provides some guidance and even safe harbor provisions with regard to determining the fair market value of company equity.[64] For private companies without a trading market for their equity, the regulations state that for the IRS to accept a valuation of private company equity, the determination must be done by ''the reasonable application of a reasonable valuation method.''[65] The regulations set forth three valuation methods that the IRS will presume to constitute a reasonable valuation if used consistently (i.e., safe harbor valuation methods). As a caveat, however, the use of a value previously calculated under any of the valuation methods listed below is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used.[66]

The three valuation methods discussed above are as follows:

- *Independent Valuation*. This is a valuation performed by an independent party qualified to value private company securities.[67] An independent valuation is the most commonly used safe harbor valuation method. Start-ups (especially in Silicon Valley) should be prepared for buyers to request copies of ''all Section 409A fair market value reports'' as a matter of course in due diligence.

- *Formula-Based Valuation*. A formula-based valuation is acceptable provided that the valuation is performed in a uniform manner for all compensatory and noncompensatory purposes, and that such valuation is used consistently.[68]

- *Start-up Company Valuation*. This safe harbor relies on the definition in the proposed regulations of ''illiquid stock'' of a ''start-up'' corporation. This safe harbor requires that the valuation be made reasonably and in good faith by a person with significant knowledge and experience in making similar valuations (even an insider of the company can perform these valuations).[69] The valuation must be evidenced by a written report that takes into account a number of factors such as value of tangible and intangible assets of the company, the present value of future cash flows, comparable company valuations, control premiums, discounts for lack of marketability, and whether the valuation method is used for other compensatory or noncompensatory purposes. This valuation method is conditioned on (1) the company not having conducted a trade or business for longer than 10 years; (2) the company having no exchange-traded class of stock, and (3)none of the stock being subject to put or call rights other than rights of first refusal or typical repurchase rights for unvested shares. Furthermore, this valuation method is not available if the company, the employee, or other service providers reasonably anticipate that, as of the valuation date, the company will undergo a change in control within the next 90 days or make a public offering of its stock within the next 180 days.[70]

Use of any of these three methods, consistently applied, will provide the company with a rebuttable pre-

[60] For an ISO granted to a holder of more than 10 percent of the company's voting power, the requirement is that the ISO be granted at an exercise price of at least 110 percent of fair market value, although it appears that if the ISO fails for this reason, but the grant is still made at fair market value (rather than 110 percent of fair market value), then the grant may still meet the nonstatutory stock option requirements for exemption under Section 409A.

[61] Treas. Reg. § 1.409A-1(b)(5)(i)(A) .

[62] Treas. Reg. § 1.409A-1(b)(5)(iii) .

[63] Treas. Reg. § 1.409A-1(b)(5)(iv)(A) .

[64] Final regulations were issued April 10, 2007. 72 Fed. Reg. 19,234 (April 17, 2007).

[65] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2) .

[66] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(1) .

[67] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(i) .

[68] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(ii) . The consistent use of a fixed formula can be constraining for a company, and many practitioners' comments on this provision as drafted in the proposed regulations suggested that this safe harbor was unlikely to be widely used. The final regulations modified the proposed regulation slightly in light of these comments, although the consistent use of a fixed formula for an emerging company even under the final Section 409A regulations could lead to valuation outcomes that bear little relation to the value that might be negotiated at arm's length. The principal reason for this is that emerging companies' financial performance tend to be very lumpy and volatile, characteristics which do not lend themselves well to consistent formula-based valuation methodologies.

[69] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii) . The final regulations clarify that, generally, significant experience means at least five years of relevant experience in fields such as business valuation or appraisal, financial accounting, investment banking, private equity, secured leading, or other comparable experience in the line of business or industry in which the company operates.

[70] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii) .

sumption that the company's fair market value determination was reasonable. To rebut this presumption, the IRS would have to show that either the method or the application of the method was ''grossly unreasonable'' under the circumstances.[71] Accordingly, the IRS will bear the burden of proof in such cases.

A company is not required to use one of the safe harbor valuation methods.[72] A company is free to use any reasonable valuation method; however, the company will not have the rebuttable presumption in its favor as it would under a safe harbor method.[73] In such a case, the company should be prepared to defend the reasonableness of its chosen valuation method based on the factors described in the regulations.

#### d. Amending an Outstanding Option

Amending an ISO historically carried a risk that the amendment could be deemed a ''disqualifying modification'' that might change the ISO into an NSO, depending on a number of considerations, including whether the term of the option was being amended and whether a spread existed between the fair market value and the exercise price at the time of the modification.[74] This risk is heightened today because the Section 409A exclusion for ISOs does not apply to a modification, extension, or renewal of an ISO that is treated as the grant of a new option that is not an ISO under the general tax regulations.[75] Thus an ISO that converts to an NSO would become subject to Section 409A's five-part NSO exemption test as outlined above *as of the date of original grant* of the option.[76]

Options are sometimes extended in connection with termination of an executive's employment with the company. An extension will be exempt if the extended period does not exceed the earlier of expiration of the option's original term or the 10th anniversary of the original date of grant.[77] Also, the Section 409A rules provide relief for extensions of the terms of underwater options.[78] However, because ISOs may by definition not be exercised greater than 90 days following a termination, an extension of an option exercise period past 90 days from the date of termination of employment will cause the option to lose its ISO status and be treated as an NSO if the holder actually utilizes the extension period.[79] This may result in a negative tax consequence to the executive if he or she intends to exercise the option when there is a spread and hold the equity.

[71] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2) .
[72] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(3) .
[73] Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2) . Neither issue should present a substantial obstacle for a company, however. Several Section 409A valuation companies offer valuations in as little as ten days and reports are often relatively inexpensive.
[74] Treas. Reg. § 1.422-2(a)(3) .
[75] Treas. Reg. § 1.409A-1(b)(5)(ii) (citing Treas. Reg. § 1.424-1(e) ). For this purpose, a ''modification'' means ''any change in the terms of the option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that gives the optionee additional benefits under the option regardless of whether the optionee in fact benefits from the change in terms.'' Treas. Reg. § 1.424-1(e)(4) .
[76] Treas. Reg. § 1.409A-1(b)(5)(i)(A) and 1(b)(5)(ii).
[77] Treas. Reg. § 1.409A-1(b)(5)(iv)(C) .
[78] *Id.*
[79] Code § 422(a)(1).

### 4. Other Share-Based Awards

The most common types of equity awards are discussed above. Numerous additional types of equity-based awards are increasingly common to start-ups. Arguably the three most common such awards are as follows:

- *Restricted Share Units (RSUs)*. RSUs are share-based awards that vest and ''settle'' (i.e., are satisfied) in either company equity or other property (e.g., cash). No 83(b) election may be filed with regard to RSUs because an RSU award agreement represents only a contract for the contingent future grant of some benefit rather than actual equity subject to vesting (such as restricted stock in a corporation).

- *Phantom Share Awards*. Phantom share awards are awards the value of which is determined by the value of company equity, but which are paid in cash or another form of non-equity. Such awards are designed to align award-holders' interests with equity-holders without expanding the enterprise's ownership pool. For example, an executive receives 50,000 phantom share units, the value of each of which equals the value of one share of company common stock. Company equity is worth $4 per share when the units are granted and $12 per share when units vest. On vesting the holder would receive a payment of $600,000 in consideration for the phantom share award ($12 multiplied by the number of phantom share award units held).

- *Share Appreciation Rights (SARs)*. SARs are similar to phantom share awards, above, but with a value equal to the positive difference, if any, between the value of company stock at grant versus when the award vests. If the executive in the example above held SARs rather than phantom share awards, the executive would have received a payment of $400,000 upon vesting ($12 minus $4 multiplied by the number of SAR units held). Note that in the partnership or limited liability context, a share appreciation right is conceptually equivalent to a phantom profits interest.

In the case of these other share-based awards, vesting refers to the event that causes the holder's right in such award to no longer be subject to a ''substantial risk of forfeiture.''[80] Some awards immediately settle upon vesting (i.e., are immediately converted into cash or company equity), while other awards undergo a post-vesting delayed settlement period (e.g., one-fourth of the underlying award may be converted into cash or company equity for every month of service following the vesting date). While the distinction seems superfluous as applied to time-based vesting awards, it is increasingly common as applied to performance-based awards. For example, an award might provide that it vests based on absolute total shareholder return over a three-year period. Once the period ends and the amount of vesting is calculated, settlement of the vested portion of the award may occur over a certain number of months or years thereafter, subject to the holder's continued service with the company.

### 5. Vesting: Common Practice and Market Standards

Regardless of the type of equity or equity-based plan selected, nearly every possible vesting arrangement has, at some point or another, been implemented. Market standards in this regard often depend on the start-up's growth phase, as discussed below.

[80] Code § 83(c).

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#### a. Founder Stage

At the founder stage of a company's existence, vesting is particularly useful to ensure that if any founder decides to leave the company, the founder does not take all of his or her equity out of the company. That equity—referred to as ''founder's equity''—is usually purchased at a very low price, and the co-founders do not want the departing founder to take, for example, one-third of the ownership of the company with him or her when the departing founder will no longer be contributing any services to the company.[81] A typical founder's vesting schedule would be monthly vesting over 48 months, subject to the founder's continued service to the company.

#### b. Recruitment Stage

Vesting continues to be favored by founders and outside investors alike as the company moves beyond the founder stage to recruiting and retaining outside executives to join the emerging company as key personnel. At the recruitment stage, an incoming executive may receive founders' treatment as to equity vesting, but more often the outside executive's vesting involves a ''cliff'' pursuant to which there is no vesting for the first year of employment or consultancy, and then at the end of the first year, 25 percent of the equity will vest, and thereafter, 1⁄48 of the total shares will vest each month. In this manner, if company executives (who may still be inexperienced and prone to missteps) make an incompatible hire and the parties agree on a separation after a few months, the company is not ''stuck'' with a minor shareholder whose employment, for whatever reason, did not work out.[82]

As value is built up inside the company, particularly once the value of the company has been validated by an outside investment in the company, vesting continues to act as a strong retention tool: the employee subject to vesting wishes to remain with the company to continue to ''earn out'' the valuable equity through vesting and free it from the company's repurchase right, or in the case of an option, gain the right to purchase more and more of the equity at the fixed exercise price of the option.

#### c. Fundraising Stage

As discussed early in this chapter, often if founders have been working at a company for a long period before receiving financing, they may be substantially or fully vested by the time they negotiate an outside financing with venture capital investors. Motivated by the same retention goals as discussed above, the outside investors are unlikely to invest in the company without having the key employees (who are likely the founders) agree to subject all or a part of their equity again to vesting. This is sometimes referred to as ''revesting'' the equity. This action gives the investors some comfort that the key employees will not decamp the company immediately after the financing.

#### d. Market Trend: Dual Vesting

Over the last few years, there has been a notable uptick in the number of start-ups using dual-vesting RSUs that are subject to a time-based vesting condition and also a secondary vesting condition, typically a liquidity-event condition, both of which must be satisfied for the award to vest and settle.[83] Such an RSU might provide that upon a liquidity event, the award will fully vest for any current service providers and will vest as to whatever portion had achieved time-based vesting for any former service providers.

#### e. Acceleration of Vesting

Each person subject to vesting wishes to be free of the vesting restrictions as soon as possible. It can be difficult for some executives to negotiate a departure from the basic vesting standard of a 25 percent cliff vesting provision or a straight 1/48 of the award vesting each month; however, it is possible, and quite normal, to negotiate for acceleration of vesting in certain special circumstances, most commonly one of the following situations:

- *Single-trigger Acceleration*. A change in control of the company or a qualifying termination of the holder's employment.[84]

- *Double-trigger Acceleration*. A change in control of the company followed by a qualifying termination of the holder's employment.[85]

An incoming executive will usually negotiate for some form of double-trigger acceleration. However, as stated above, shareholders intent on maximizing the value of their equity in the company are usually unwilling to agree to single-trigger acceleration. The reason for this reluctance is that the immediate acceleration of award vesting of a key executive's equity in connection with an acquisition will make it difficult for the acquirer of the company to retain the services of that executive after the acquisition. Because the value of a key executive's awards is often quite large (often in the tens of millions of dollars and sometimes higher), the company's acquiror will often not be able to arrange a com-

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[81] This is the reason that outside investors will often demand that founder's stock be subjected to new vesting conditions as a condition to such investment, as discussed earlier in this chapter.

[82] Depending on the situation and bargaining power, start-ups may add a repurchase right into the documents, providing that upon a termination of the outside executive's employment, the company may buy back any shares held by such person at fair market value (or, if the departure was for ''cause,'' then perhaps at the lower of fair market value or the value at grant).

[83] This practice has existed for some time, but Facebook's (and later Zynga's) use of RSUs subject to both a time-based and a liquidity-event based vesting condition no doubt raised the awareness and acceptance of this type of award for entrepreneurs both within and beyond Silicon Valley.

[84] Single-trigger acceleration nearly always refers to a change in control rather than a qualifying termination of the executive's employment.

[85] Typically a termination a fixed number of months prior to a change in control, or after a document has been executed the consummation of which would constitute a change in control, or within a fixed period of time after the consummation of a change in control (usually 12 months). A form of double-trigger arrangement for a restricted stock purchase agreement could look like the following:

> Notwithstanding the foregoing, in the event that Purchaser's continuous status as a Service Provider is terminated by the Company without Cause [or by Purchaser's resignation for Good Reason, in each case] within [_____] months after a Change in Control, [_____%] of the total number of Shares that have not vested as of the date of such Change in Control shall immediately vest.

pensation package that sufficiently motivates for the executive to remain with the company if the executive's awards accelerate.[86] For this reason, many acceleration schemes are structured as double-trigger rather than single-trigger. These double-trigger arrangements usually provide an acquiror with sufficient comfort that the value built into the executive's equity compensation will cause the executive to wish to remain with the company after the closing, and only if the acquirer chooses not to retain the executive will the executive depart the company with all of his or her equity vested. This arrangement also satisfies the main investors in the company because it motivates the key executives to consummate a favorable acquisition but does not cause the acquirer to divert significant value from the acquisition into a compensation package for the executives.

### 6. Accounting for Equity and Equity-Based Awards

The accounting for equity and equity-based awards (most commonly stock purchases and stock options) has been greatly simplified under the Financial Accounting Standards Board's FAS 123R, Share-Based Payment (codified as ASC Topic 718—Stock Compensation).[87] In summary, under ASC 718, a company is required to measure the cost of the employee services received in exchange for the equity award to determine the fair value of such award on the date of grant. The company is then required to recognize that cost over the period during which the employee is required to provide services under the award—for equity options, this is usually the vesting period. Thus, a company will recognize a financial statement expense—equity compensation—for the grant of options.[88] Accordingly, in making a large option grant to an incoming executive, the company must recognize that there will likely be a large compensation charge that will be recognized over the vesting period of the option. These charges will have the effect of reducing the company's reported earnings for financial statement purposes. Many emerging companies run losses for many years in any event, and so an equity compensation cost that ASC 718 requires to be recorded will not usually motivate the company to alter its recruiting strategy with regard to the executive and require the executive to purchase his or her equity when joining the company.

Share-based payments may be classified as either debt (i.e., a liability) or as equity for accounting purposes, a classification for which equity plan share withholding for income tax purposes plays an unlikely but central role. One of the requirements for an award to qualify for equity classification under generally accepted accounting principles (GAAP) is that an entity cannot partially settle the award in cash (i.e., in a ''net settlement'' exercise, in which part of the resulting shares are immediately surrendered to cover the award's settlement-related tax obligation) in excess of the employer's ''minimum statutory withholding requirements,'' the consequence being that the entire award must be measured and classified as a liability.[89] On March 30, 2016, the FASB rules in this regard changed for the better.[90] For equity grants in fiscal years beginning after December 15, 2016, equity plans may provide for withholding based on maximum statutory tax rates in the participants' applicable jurisdictions rather than the previous rule's more cumbersome ''minimum rates'' limitation.[91] This shift is welcome news for company accountants previously tasked with threading the needle between insufficient tax withholding and greater-than-minimum withholding that risked reclassifying equity awards as debt.

## D. The Golden Parachute Rules: Sections 280G and 4999

### 1. Overview

Under Code Sections 280G and 4999 's ''golden parachute'' provisions (typically referred to jointly as Section 280G in shorthand), if in connection with a change in effective control of a corporation a ''disqualified individual''[92] will or may receive payments in the nature of compensation the aggregate present value of which is equal to or in excess of three times his or her ''base amount,''[93] then all such amounts over one times such base amount will be subject to a 20 percent excise tax to the disqualified individual and will lose any deductibility to the corporation.[94] For example, if a disqualified individual's base amount equals $100,000, and such person receives $299,999 in the nature of compensation in connection with the change in control, then the Section 280G analysis ends with no negative effect. However, if such person will or may receive $300,000 in the nature of compensation in connection with the change in control, then $200,000 (i.e., everything over one times such person's base amount) will be subject to a 20 percent excise tax to such person and the corporation will be unable to take a tax deduction on such amount, unless an exception applies (as discussed below).

Accelerated vesting and other severance amounts that are or may be paid in connection with a change in control can and usually are counted in the calculation of

[86] Even if an acquiror were to structure such a generous compensation package, the acquiror would likely insist on detracting from the acquisition consideration accordingly—not an appealing proposition for the principal investors in the target company.

[87] Under FASB's Accounting Standards Codification project, FAS 123R, Share-Based Payment, is codified as ASC Topic 718. See http://www.fasb.org/home and http://fasb.org/pdf/fas123r.pdf .

[88] FAS 123R provides that for most restricted stock purchase arrangements for emerging companies, no such equity compensation expense need be recognized. FAS 123R, at para. 11.

[89] Accounting Standards Codification (ASC) Topic 718 at 86.

[90] FASB Accounting Standards Update No. 2016-09 (March 2016).

[91] *Id.*

[92] Code § 280G(c). The term ''disqualified individual'' means any individual who is (1) an employee, independent contractor, or other person specified in regulations by the Secretary who performs personal services for any corporation, and (2) is an officer, shareholder, or highly-compensated individual (which term only includes an individual who is (or would be if the individual were an employee) a member of the group consisting of the highest paid 1 percent of the employees of the corporation or, if less, the highest paid 250 employees of the corporation).

[93] Code § 280G(b)(3). The term ''base amount'' generally means a person's average annualized W-2 compensation over the five years ending on the year preceding the date on which the change in control occurs, or, if shorter, the period of time as the person has provided service to the company.

[94] For an additional discussion of Section 280G, see the chapter Using Equity to Compensate Executives: Part I - Taxation , at ''I.R.C. § 280G—Golden Parachutes .''

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whether the executive is receiving a "parachute payment."[95] For accelerated vesting, only the acceleration value of the award is typically counted (for example, if the award would have vested under its terms one month following the change in control anyway, then the fact that such amount may be paid in the change in control instead of one month later would likely convey only a small value to the disqualified individual for Section 280G purposes). However, the Code "presumes" that agreements entered into or substantially modified within one year prior to the effective date of the change in control are parachute payments, and thus the entire total value of such agreements is counted for Section 280G purposes, unless the company can rebut the presumption by clear and convincing evidence.[96]

For a change in control transaction of sufficient value, vesting acceleration in connection with a change in control alone often amounts to a parachute payment that will suffer these excise taxes and nondeductibility. This consequence applies whether the vesting acceleration is in an option agreement or equity purchase agreement. Practically, however, except for the rare start-up company that gets acquired within the first year or two of its existence,[97] founders who purchase their equity pursuant to a restricted equity purchase agreement are usually substantially vested by the time of an acquisition, and the Section 280G provision do not have a fierce bite (particularly given the exceptions discussed below).

### 2. Section 280G Arrangements

Various executive compensation documents tend to proactively anticipate the eventual application of Section 280G in a variety of ways, and different executives often receive disparate treatment in this regard. Four common examples of Section 280G arrangements are summarized below, followed by one increasingly uncommon example:

- *No Section 280G arrangement*: the executive's parachute payments will be calculated without regard to the Section 280G payment thresholds and without any "gross-up" by the company;
- *"Cut-back" arrangement*: the executive will receive a maximum of the executive's Section 280G safe harbor (i.e., one dollar less than three times his or her base amount);[98]
- *"Best payment" arrangement*: the executive will receive the amount that provides the greatest after-tax payment (be that amount one dollar less than three times his or her base amount or the full parachute payment less the excise tax), in either case without any "gross-up" by the company;[99] and
- *"Gross-up" arrangement*: the executive will receive the full parachute payment amount and be

[95] "May be" is interpreted broadly for golden parachute purposes. For example, if an award is subject to double-trigger acceleration, then the golden parachute calculations should assume both triggers occur (i.e., the change in control is consummated and a qualifying termination occurs within the acceleration window, even if no termination actually occurs). A notable exception to this assumption is when contrary facts would produce a higher net golden parachute payment. For example, if the executive were to receive a retention payment on remaining with the company beyond the award's double-trigger acceleration period, and the value of the retention payment exceeded the value of the double-trigger acceleration, then for golden parachute calculation purposes it would be assumed that no such termination would occur.

[96] Treas. Reg. § 1.280G-1 (Q/A-25). For example, if an option award pertaining to 1,200,000 shares containing double-trigger acceleration is issued to a disqualified individual in November 2016 with an exercise price of $1.50 and a change in control occurs in October 2017, the net consideration of which is $6.00 per share, the award could be calculated as representing a $5,400,000 parachute payment unless the company could rebut the presumption that the agreement represents a parachute payment by clear and convincing evidence. A company could potentially rebut the presumption if the grant were part of a documented annual grant process, and in such amounts reflective of the company's ordinary business practices.

[97] For example, YouTube, Inc., which was founded in February 2005 and agreed to be acquired by Google in November 2006 for approximately $1.6 billion of Google stock. Since the company had only been in existence for slightly more than 18 months at the time of the acquisition, there is a possibility that not all of the founders' shares had vested in this short time. There may have been acceleration provisions in the founders stock purchase agreements.

[98] A "cut-back" arrangement denies the executive some of the benefit of the vesting acceleration, and could represent a loss of millions of dollars to the executive. A "cut-back" arrangement might be structured as follows:

> Limitation on Payments. In the event that the severance and other benefits provided for in this Agreement or otherwise payable to the Purchaser (i) constitute "parachute payments" within the meaning of Section 280G of the Code, and (ii) would be subject to the excise tax imposed by Section 4999 of the Code (the "Excise Tax"), then Purchaser's benefits under this Agreement shall be delivered as to such extent which would result in no portion of such benefits being subject to the Excise Tax.

[99] A "best net payment" arrangement might be structured as follows:

> In the event that the severance and other benefits provided for in this Agreement or otherwise payable to the Purchaser (i) constitute "parachute payments" within the meaning of Section 280G of the Code, and (ii) would be subject to the excise tax imposed by Section 4999 of the Code (the "Excise Tax"), then Purchaser's benefits under this Agreement shall be either (A) delivered in full, or (B) delivered as to such lesser extent which would result in no portion of such benefits being subject to the Excise Tax, whichever of the foregoing amounts, taking into account the applicable federal, state and local income taxes and the Excise Tax, results in the receipt by Purchaser on an after-tax basis, of the greatest amount of benefits, notwithstanding that all or some portion of such benefits may be taxable under Section 4999 of the Code. Unless the Company and the Purchaser otherwise agree in writing, any determination required under this section shall be made in writing by the Company's independent public accountants (the "Accountants"), whose determination shall be conclusive and binding upon the Purchaser and the Company for all purposes. For purposes of making the calculations required by this section, the Accountants may make reasonable assumptions and approximations concerning applicable taxes and may rely on reasonable, good faith interpretations concerning the application of Section 280G and 4999 of the Code. The Company and the Purchaser shall furnish to the Accountants such information and documents as the Accountants may reasonably request in order to make a determination under this section. The Company shall bear all costs the Accountants may reasonably incur in connection with any calculations contemplated by this section.

''grossed-up'' by the company for the excise taxes that he or she must pay on the parachute payments, plus the additional excise and other taxes due on such gross-up payment (due to this tax stacking, a gross-up can and often is a very expensive proposition for the company).[100]

### 3. Defusing Section 280G

Despite its complex nature, several ''outs'' to Section 280G exist:

#### i. Entity Exemption

Numerous types of enterprises are automatically exempted from Section 280G, including most partnerships,[101] most limited liability companies,[102] and small business corporations / S corporations.[103] As a caveat, Section 280G has an expansive concept of affiliates, and a Section 280G analysis should look to all entities within the target enterprise's organizational chart.[104]

#### ii. Shareholder Approval

For private corporations only, executives may submit their parachute payment to a vote of the company's disinterested shareholders. This approach entails the preparation of four different documents:

■ *280G Calculations*. The company (or its outside Section 280G expert, of which there are several) must prepare detailed calculations confirming each disqualified individual and the exact parachute payments that each such person will or may receive. The calculations are typically updated through several rounds of comments as deal mechanics change or evolve.

■ *Disqualified Individual Waiver*. As a prerequisite to the shareholder vote, the executive must agree to waive his or her parachute payment to the extent the shareholders do not approve it. An individual should only waive and submit to the shareholders everything at or over three times such person's base amount. For example, if a disqualified individual's base amount is $100,000 and such executive will receive a $1,000,000 parachute payment, such executive should submit $700,001 to the shareholders for approval. This approach is more digestible to shareholders than a waiver of the full $1,000,000 because the underlying amount is smaller, and safer for the executive because, should a vote fail, the executive will not have forfeited his or her entire parachute payment.

■ *Information Statement*. The Section 280G information statement is a narrative document typically running 8 to 15 pages, detailing for the target company shareholders each form of parachute payment to which each disqualified individual submitting such payment to shareholders is entitled, or the circumstances under which such an award might be paid (for example, termination without cause or resignation for good reason within 12 months following the change in control). For each type of payment, the company should disclose the date of underlying agreement and all pertinent award details, including the estimated Section 280G value of such payment. Following the award-by-award discussion, the information statement should produce a table listing each disqualified individual, his or her base amount, the aggregate Section 280G payments to which such person is eligible and the aggregate amount being submitted for shareholder approval. Regardless of whether they feel confident about the vote itself, disqualified individuals are often sensitive regarding the disclosure of such specific compensation arrangements to shareholders.

■ *Shareholder Approval Form*. The shareholder approval must be separate from the vote to approve the change in control and sent to all shareholders entitled to vote, even minority shareholders whose votes are not needed to reach 75 percent in a specific case.[105] The vote may be submitted on an individual (i.e., per disqualified individual basis) or a ''slate'' basis (that is, one thumbs up or thumbs down vote as to all disqualified individuals' parachute payments). In many corporations controlled by venture capital investors, this vote can and often is achieved; in companies where the vote is not guaranteed, there can be a great deal of tension on the part of the executive who has potentially millions of dollars of vesting acceleration riding on the 75 percent vote of disinterested shareholders. Non-individual (i.e., entity) shareholders are included in the shareholder vote, and if (i) a ''substantial'' portion of the entity shareholder's assets comprises stock in the corporation undergoing the change in ownership or control, and (ii) the entity shareholder owns at least 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control, then the entity shareholder's approval must itself be approved by a separate vote of the persons who hold more than 75 percent of the voting power of the entity shareholder.[106]

Following this process (including all Section 280G rules and procedures beyond the scope of this chapter), if the parachute payment is approved by 75 percent of the disinterested shareholders, then the payment will not be subject to excise tax nor will the company be denied deductibility for the payment.[107] If the vote is not

[100] Section 280G gross-ups were popular for many years but, alongside the rise of shareholder advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis, which typically strongly oppose such arrangements, Section 280G gross-ups have rapidly fallen out of favor and are no longer market practice. A ''gross-up'' arrangement might be structured as follows: ''Notwithstanding anything to the contrary, you shall be entitled to a full excise tax gross-up (including a gross-up for any taxes on such payment) on any payments subject to the excise tax provisions of Sections 280G or Section 4999 of the Internal Revenue Code.''

[101] But not publicly traded partnerships treated as corporations under Code § 7704(a) . Treas. Reg. § 1.280G-1 (Q/A-45).

[102] Except those that elect to be taxed as corporations.

[103] Determined without regard to whether the corporation has actually filed for S corporation status and without regard to whether the corporation has any nonresident alien shareholders. Code § 280G(b)(5)(A)(i) (citing Code § 1361(b) ).

[104] Section 280G's concept of ''affiliate group'' is explained more fully in Treas. Reg. § 1.280G-1 (Q/A-46).

[105] Treas. Reg. § 1.280G-1 (Q/A-7)(e), Example 6.

[106] Treas. Reg. § 1.280G-1 (Q/A-7)(b)(3)(ii) (''Stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, gross fair market value means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.'').

[107] Treas. Reg. § 1.280G-1 , Q&A-7(a). In addition, there is a requirement that adequate disclosure of the payments be pro-

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obtained, the executive is denied the payments that he or she waived in connection with the vote.

#### iii. Change in Control Timing

When the parties estimate a change in control will occur in the later part of the year, a discussion often ensues on whether the closing should occur prior to or following year end. Section 280G base amounts are calculated based on the five years ending on the year preceding the year in which the change in control occurs, so a change in control occurring December 31, 2017 will entail base amounts calculated from 2012 through 2016, whereas a change in control occurring on January 1, 2018 will entail base amounts calculated from 2013 through 2017. Depending on the particular facts and circumstances, a Section 280G problem on one side of December 31 might completely disappear on the other side.

Similarly, if the company is dogged by agreements entered into or materially amended 11 months prior to the anticipated change in control and the company does not feel confident that it can demonstrate by clear and convincing evidence that such agreements are not parachute payments, then delaying the closing until a year and a day after such agreements were entered into or materially amended, and thus reducing the parachute payment value thereof from the entire value to the acceleration value (if any) might be easier than pursuing the shareholder approval exemption.

### V. Other Executive Compensation Benefits

In bringing an executive into the emerging company, the principal components of executive compensation will often be cash, form of bonus, and equity. Typically, when recruiting an executive from another geographic region, some additional minor benefits are added to the executive's compensation package. Some of these are reflected in the form of an executive offer letter agreement that is included as a practice aid to this chapter. These generally fall under the category of ''relocation assistance.''[108]

vided to those being asked to vote on the payments. *Id.* at (a)(1).

[108] A market-standard relocation assistance package may include, depending on the executive's seniority, (1) a housing allowance to reimburse the executive for the cost of temporary housing while he or she searches for a home in the new area; (2) a supplemental housing allowance to reimburse the executive for some period of time for the higher cost of housing in the new region; (3) moving expense reimbursement, including the cost of moving vehicles to the new region; (4) round-trip airfare to the executive's prior city of residence (typically once per year/six months/month), with the seat class often specified in the agreement; (5) reimbursement for a certain number trips to the region to look for housing; and (6) assistance in selling the executive's current home—this might take the form of paying for part of the realtor commission for the sale of the executive's home.

Start-ups also pride themselves on unexpected perquisites that, in general, represent a small cost to a small workforce, such as museum or gym discounts, a company cellphone, on-site laundry (i.e., ''Purple Tie'') services, free lunches, etc. As a company matures, these benefits might be supplemented (at least to key personnel) with financial planning and tax preparation services, company-funded life insurance, car and driver, use of the company plane or unlimited airfare reimbursement, home security systems, personal security, etc.

Though tax optimization strategies always exist, these mechanisms often have tax consequences, and some of these payments are subject to withholding. Accordingly, consulting with the company's tax accountants and/or outside counsel on the proper structuring and administration of these arrangements is important.

### VI. Closing: Documenting Compensation Arrangements

Whatever the precise compensation package for executives, directors, advisors and other independent contractors, it should be properly documented. There are usually several documents that make up the entirety of the executive compensation arrangements in the emerging company. When working solely with founders, their agreements will usually consist of a restricted equity purchase agreement, an 83(b) election form, an employee handbook (when the company begins hiring employees), a confidential information agreement, and an arbitration agreement.[109] At the very least, start-ups should get ''outside executive ready'' by preparing the following documents:

- an employment offer letter agreement (this is in the form of a letter but is no less a contract than one in a contract form),
- a confidential information agreement,
- an arbitration agreement,
- an equity incentive plan, comprising one or more of the following forms: an equity option agreement, a restricted equity agreement, and a restricted stock unit agreement, any of which might be time-based or performance-based (or both), and
- an employee handbook.

[109] It has become common to separate the arbitration agreement from the other employment- or stock-related agreements to address the situation where the arbitration agreement is declared void due to unconscionability or based on public policy. This will allow the other agreements to continue in force without the risk of being negated because a central provision was declared void.