

Start-Up Compensation Designs: Focus on the Founders (Part 1 of 2)

Presentation for:

Executive Compensation Academy –
(Monthly Training Series)
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- Questions during this presentation
 - We encourage questions (even though your audio lines are muted)
 - To submit a question, simply type the question in the blank field on the right-hand side of the menu bar and press return
 - If time permits, your questions will be answered at the end of this presentation. And if there is insufficient time, the speaker will respond to you via e-mail after this presentation

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 - This presentation is being recorded for internal purposes only
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 - A purpose of the webinar series is to provide FREE CE credits
 - To that end, each presentation is intended to provide 1 credit hour in the following areas:
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About Anthony “Tony” Eppert



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- Tony practices in the areas of executive compensation and employee benefits

- Before entering private practice, Tony:
 - Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals for the Sixth Circuit
 - Obtained his LL.M. (Taxation) from New York University
 - Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
 - Editor-in-Chief, Journal of Medicine and Law
 - President, Tax and Estate Planning Society

Upcoming 2023 Webinars

- 2023 webinars:
 - Start-Up Compensation Designs: Focus on Key Employees (Part 2 of 2) (3/9/23)
 - Current 280G Mitigation Techniques (4/13/23)
 - Private Equity Compensatory Design Trends & Practices (5/11/23)
 - Equity Awards & Employment Taxes: Design Considerations (6/8/23)
 - Form 4 Training Course (7/13/23)
 - Anatomy of ISS: A Current Compensatory Perspective (8/10/23)
 - Preparing for Proxy Season: Start Now (Annual Program) (9/14/23)
 - PubCo Governance & Internal Controls: A Compensatory Perspective (10/12/23)
 - Keep It Boring: Drafting Miscellaneous Provisions in a Contract (11/9/23)
 - [Topic TBD] (12/14/23)

Sign up here: <https://www.huntonak.com/en/insights/executive-compensation-webinar-schedule.html>

Our Compensation Practice – What Sets Us Apart

- Compensation issues are complex, especially for publicly-traded issuers, and involve substantive areas of:
 - Tax,
 - Securities,
 - Accounting,
 - Governance,
 - Surveys, and
 - Human Resources

- Historically, compensation issues were addressed using multiple service providers, including:
 - Tax lawyers,
 - Securities/corporate lawyers,
 - Labor & employment lawyers,
 - Accountants, and
 - Survey consultants

Our Compensation Practice – What Sets Us Apart (cont.)

- The members of our Compensation Practice Group are multi-disciplinary within the various substantive areas of compensation. As multi-disciplinary practitioners, we take a holistic and full-service approach to compensation matters that considers all substantive areas of compensation



Our Compensation Practice – What Sets Us Apart (cont.)

- Our Compensation Practice Group provides a variety of multi-disciplinary services within the field of compensation, including:

Traditional Consulting Services

- Surveys
- Peer group analyses/benchmarking
- Assess competitive markets
- Pay-for-performance analyses
- Advise on say-on-pay issues
- Pay ratio
- 280G golden parachute mitigation

Corporate Governance

- Implement “best practices”
- Advise Compensation Committee
- Risk assessments
- Grant practices & delegations
- Clawback policies
- Stock ownership guidelines
- Dodd-Frank

Securities/Disclosure

- Section 16 issues & compliance
- 10b5-1 trading plans
- Compliance with listing rules
- CD&A disclosure and related optics
- Sarbanes Oxley compliance
- Perquisite design/related disclosure
- Shareholder advisory services
- Activist shareholders
- Form 4s, S-8s & Form 8-Ks
- Proxy disclosures

Design/Draft Plan

- Equity incentive plans
- Synthetic equity plans
- Long-term incentive plans
- Partnership profits interests
- Partnership blocker entities
- Executive contracts
- Severance arrangements
- Deferred compensation plans
- Change-in-control plans/bonuses
- Employee stock purchase plans
- Employee stock ownership plans

Traditional Compensation Planning

- Section 83
- Section 409A
- Section 280G golden parachutes
- Deductibility under Section 162(m)
- ERISA, 401(k), pension plans
- Fringe benefit plans/arrangements
- Deferred compensation & SERPs
- Employment taxes
- Health & welfare plans, 125 plans

International Tax Planning

- Internationally mobile employees
- Expatriate packages
- Secondment agreements
- Global equity plans
- Analysis of applicable treaties
- Recharge agreements
- Data privacy

Purpose of Presentation

- The purpose of this presentation is to focus on Founder compensation designs and navigating issues related to such designs, including:
 - Qualifying and maintaining favorable tax attributes associated with “founders stock”,
 - Picking the best vesting schedules,
 - Resetting vesting schedules in a funding round financing,
 - “top-up” equity grants,
 - Executive contracts, and
 - Governance provisions

- This is Part 1 of a 2-part series. Part 2 will cover key employee compensation of a start-up company

Entity Structure

- This presentation assumes that the entity structure in question is a corporation taxed as either a C corporation or an S corporation
- Compensation of individuals within a pass-through structure such as a partnership or an LLC taxed as a partnership are the subject of a different presentation and slide deck

Who Is a Founder

- Founders are the individuals who were present when the entity was first created
 - Typically, founders were important to the process of creating the new enterprise
- There is a subtle distinction between a founder and a service provider who became employed with the Company at or near the inception of the Company

Founder's Stock

- Founder's stock is typically stock that is granted at or near the time that the company was formed

- Founder's stock tends to have different rights and features than stock granted to key employees in exchange for service, or stock purchased by key employees. For example, founder's stock tends to contain favorable:
 - Vesting conditions and accelerants,
 - Rights of first refusal,
 - Drags and tags,
 - Rights of repurchase provisions,
 - Co-sale provisions, and
 - Co-registration provisions upon an IPO and associated lock-up provisions

Vesting Schedule & 83(b) Elections

- If a founder receives fully vested stock in the Company and such receipt is deemed to be compensatory, then the founder will have ordinary income tax on the fair market value of such stock as of the date of grant
 - “Fair market value” to be determined by the Board in its reasonable discretion

- But if the stock granted contains a vesting schedule and no timely 83(b) election is filed, then
 - The founder would recognize ordinary taxable income equal to the fair market value of the underlying stock (less any amount paid, such as par value) as of the earlier of:
 - The date the stock becomes transferable, or
 - The date the forfeiture restrictions lapse (*i.e.*, the vesting date or dates)

 - Until such time, any dividends received by the founder would be treated for tax purposes as compensation and not as dividends

 - After there is a tax transfer, any later sale of the stock would be treated as capital gain or loss equal to the difference between the sale price and the holder’s tax basis

Vesting Schedule & 83(b) Election (cont.)

- In contrast to the prior slide, if the founder makes a timely 83(b) election with respect to unvested stock:
 - The founder could attempt to capture as much of the anticipated future appreciation of the underlying stock at long-term capital gains rates by making an “83(b) election” within 30 days from the date of grant
 - The purpose of an 83(b) election is to limit the ordinary taxable income element to the value of the stock on the date of grant (which is hopefully lower than the amount of ordinary taxable income the founder would otherwise recognize at the time of vesting)
 - This means the founder would be taxed at the time of the initial grant (at the time when the fair market value of the underlying stock is hopefully lower, compared to waiting until vesting)
 - Thereafter, any increase in the fair market value of the underlying stock subject to the 83(b) election would be taxed at capital gains rates if the founder later sells the underlying stock

- The tax treatment to the Company is as follows:
 - If the founder is an employee, the Company would have a withholding obligation and employment taxes at the time the founder recognizes ordinary income
 - Additionally, the Company would have a corresponding compensation deduction at that time

Example of Pros & Cons for an 83(b) Election

- The following example compares the tax consequences of receiving restricted stock with and without an 83(b) election
 - Please note this is a hypothetical example using hypothetical tax rates!

- Assumed Facts
 - Employee receives 10,000 shares of restricted stock on February 1, 2021, when the fair market value per share was \$10.00
 - The award vests 100% on the two-year anniversary of the date of grant (*i.e.*, no interim or graded vesting)
 - When the 10,000 shares vest on January 31, 2023, the fair market value per share is \$30.00
 - Employee then sells the shares for \$400,000.00 in May 2024, when the fair market per share is \$40.00

Example of Pros & Cons for an 83(b) Election (cont.)

Assuming an 83(b) Election Is Filed with 30 Days from the Date of Grant:

Ordinary income upon grant on 2/1/21:	\$ 100,000.00
Ordinary income tax on 2/1/21 (40% x \$100,000):	\$ 40,000.00
Ordinary income upon vesting 1/31/23:	\$ 0.00
Capital gain at sale 5/24 (\$400,000 - \$100,000):	\$ 300,000.00
Capital gains tax on 5/24 (23.8% x \$300,000):	\$ 71,400.00
Aggregate Tax on Award:	\$ 111,400.00

Assuming **NO** 83(b) Election is Filed:

Ordinary income upon grant on 2/1/21:	\$ 0.00
Ordinary income upon vesting 1/31/23:	\$ 300,000.00
Ordinary income tax 1/31/23 (40% x \$300,000):	\$ 120,000.00
Capital gain at sale 5/24 (\$400,000 - \$300,000):	\$ 100,000.00
Capital gains tax on 5/24 (23.8% x \$100,000):	\$ 23,800.00
Aggregate Tax on Award:	\$ 143,800.00

Example of Pros & Cons for an 83(b) Election (cont.)

- In the prior example, the tax cost to the founder for failing to make an 83(b) election is \$32,400 (\$143,800 - \$111,400)
- In sum, the greater the increase in the value of the shares during the vesting schedule, the greater the tax cost to the founder for failing to make an 83(b) election.
- However, when determining whether to make an 83(b) election:
 - The founder must carefully consider the risk that his or her employment could be terminated prior to full vesting of the Award
 - By way of an example, if the founder files an 83(b) election but his or her employment is terminated prior to vesting, then the founder will forfeit all of the shares and, using the example on the prior slide, the founder will have paid \$40,000 in tax for which he or she generally cannot claim a full refund

Reverse Vesting

- This concept tends to arise whenever an investor is contemplating an investment in the Company
 - A purpose is incentivize a founder to continue working for the Company
 - This is accomplished by either:
 - Applying a vesting schedule to stock owned by a founder that is otherwise fully vested at the time of the investment, or
 - Applying a repurchase right in favor of the Company, the price of which varies depending upon satisfaction of a vesting schedule
 - Generally, the full amount of a founder's shares would NOT be subject to reverse vesting, instead, only a portion of a founder's shares would be subject to reverse vesting (e.g., 75% or less would be subject to reverse vesting)
- In situations where reverse vesting is applied, there generally are carve-outs for good leavers and other conditions that would accelerate vesting, such as:
 - Terminated without Cause,
 - Quit for Good Reason,
 - Removal from the Board,
 - Death,
 - Disability, and/or
 - Change in Control of the Company

Reverse Vesting (cont.)

- In accordance with Rev. Rul. 2007-49, the imposition of vesting conditions on fully vested stock is analyzed in three scenarios
- Scenario 1 - new vesting restrictions on fully vested stock
 - The IRS position is that the imposition of a vesting schedule on otherwise fully vested stock does NOT result in a transfer of property under Section 83 of the Internal Revenue Code
 - For purposes of Section 83, the new vesting conditions are 100% ignored
 - The founder need not file an 83(b) election since the tax transfer previously occurred on the date the stock was originally granted
- Other 2 scenarios – fully vested stock exchanged for non-vested stock
 - There are two examples: (i) the foregoing occurs within a taxable M&A transaction, and (ii) the foregoing occurs within a non-taxable M&A transaction
 - An 83(b) election must be timely elected and filed, otherwise, there is a potential the Founder will be taxed at ordinary income tax rates on the fair market value of the stock as of the date such stock vests
 - Even though an 83(b) election is filed, Rev. Rul. 2007-49 makes clear that the gain on the spread from the date of grant though such 83(b) election would be \$0.00

Founder Guarantees a Debt in Exchange for Warrants

- An issue that arises from time to time is the situation where a CEO founder is asked to personally guarantee the Company's revolver or credit facility
 - Typically, the founder will receive warrants as consideration for guaranteeing the Company's debt obligation
 - The question is whether the warrants are deemed to be compensatory or investor related
 - If the founder is also providing personal services to the Company, then the default and presumption from an IRS perspective is that the warrants are NOT investor related and instead are compensatory

- The above point is important to keep in mind with respect to:
 - How the warrant is priced from a strike price perspective, and
 - Taxation and withholding obligations

Founders Stock – Tax Benefits

- If the founder's stock qualifies as Qualified Small Business Stock ("**QSBS**"), then generally the individual may exclude from capital gains (upon a sale of the stock) up to \$10mm or 10x the adjusted basis in the stock
 - Taxable income on the proceeds of the founder's first \$5mm is taxed at \$0.00

- Requirements to qualify under Section 1202 of the Code include:
 - The company must be a C corporation at the time the stock was acquired,
 - The company must have maintained C corporation status during "substantially all" of the founder's Holding Period
 - The founder's stock must be stock of a U.S. entity
 - The Company must have at least \$5mm in revenue or assets on the date such stock is acquired, and \$50mm or less of gross assets at all times before or immediately after it issues the stock
 - At least 80% of the value of the entity's assets must be actively used in a trade or business
 - An 83(b) election should be filed within 30 days from the date the stock was initially granted
 - The stock must be held by the founder for a period of 5 years (the "**Holding Period**")
 - The Company must agree to submit certain reports to the IRS and the Company's shareholders (however, no guidance on such exists, so the Company should be "ready" in case a request for such is provided)

Don't Forget Next Month's Webinar

- Title:
 - Start-Up Compensation Designs: Focus on Key Employees (Part 2 of 2)

- When:
 - 10:00 am to 11:00 am Central
 - March 9, 2023