USA



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Q&A

Please provide a brief overview on how an ESOP in a start-up is usually structured in your jurisdiction (of particular interest: virtual or real participation programs, market practice with regard to vesting, participation (exits, proceeds and dividends) and voting rights).

Hunton AK response: typically start-ups are conserving cash and as a result compensatory equity is a main incentive. and too, there is a combined goal for key employees to "share in the dream" with the investors (such dream being a future liquidity event). market practice is as follows:

a) typically stock options are used because optionees have "optionality" as to when to exercise. sometimes, especially if the value of the common stock is \$0.00 or near \$0.00, key employees will be granted restricted stock instead of options (for the purpose of the key employee making an 83(b) tax election, thus capturuing the ordinary income tax element at the time of grant, and capturuing all future appreciation at more favorable capital gains tax rates). synthetic equity is typically only used when the founders do not want to share in equity, but they want the employees to feel like equity holders.

b) market practice for vesting is typically 3-5 years graded vesting. using a 4 year vesting schedule as an example, 25% would become vested on the 1st anniversary of the date of grant, and then the remainder would vest pro rata over the next 3 years on a monthly basis. and too, in situations where the company is trying to drive the employee behavior of "sharing in the dream," some companies will have a vesting schedule that the employee must be employed by the company at the time of the exit event in order to vest (and or, they provide that the equity vests over the 3-5 year period, but insert a repurchase right that the com-pany is entitled to repurchase the equity at the

fair market value of the stock as of the date the employee terminated employment and not at the more favorable exit event pricing structure).

c) dividends are almost always provided with respect to restricted stock grants, but not with respect to unexercised options. as to restricted stock grants, it is common to have the dividends held in escrow with respect to unvested restricted stock, and then such are released only to the extent the restricted stock becomes vested.

d) voting rights are provided with respect to restricted stock, and with respect to option only to the extent exercised. as a governance measure, we often will include a power of attorney and irrevocable proxy that cedes voting authority for the equity in question to another person or body (e.g., the board of directors to be voted proportionate to how the board votes). we typically do this only in situations where the founders are worried about sharing ownership due to voting issues.

Please provide an overview of the respective tax situation an employee finds him-/herself in when he/she participates in a real/virtual equity investment program (applicable taxes and approximate tax burden (a) at the time of the investment and (b) at the time when revenues therefrom are received).

Subject/Topic	Incentive Stock option	Nonqualified Stock Option	Restricted Stock Award	Restricted Stock Unit / Stock Apprecia- tion Right
GENERAL CHARACTERISTICS:				
Value of Award:	Appreciation-only award. This means the participant re- ceives the difference between the exercise price and the FMV of the underlying stock as of the date the un- derlying stock is sold.	Same as ISOs.	Full-value award. This means the par- ticipant receives the difference between \$0.00 and the FMV of the underlying stock as of the date the un- derlying stock is sold.	RSUs are full-value awards, and SARs are appreciation only awards.
Type of Award:	Share-based award only.	Share-based award only.	Share-based award only.	Cash-based or share-based award, at the discre- tion of the Company. However, equity classification for ac- counting purposes (which is typically desired) cannot be maintained if the award is to be set- tled in cash or if the Company has the discretion to settle the award in cash (i.e., the presence of a cash settlement feature triggers

				liability classification for accounting pur-
Impact on Shareholder Dilution:	Compared to full- value awards, ISOs are more dilutive be- cause, due to the "at the money" strike price associated with the grant of an ISO, more shares are typ- ically required in or- der for the recipient to have a stated level of perceived value.	Same as ISOs.	Compared to appre- ciationonly awards, RSAs are less dilu- tive (assuming any purchase element is \$0.00 or par value) because, as a full value award, RSAs have a direct correla- tion between the FMV of the award on the date of grant and the perceived value of the RSA by the re- cipient.	poses). No equity dilution if the RSU/SAR is set- tled in cash. If stock-settled, then SARs have a similar impact as ISOs, and RSUs have a similar impact as RSAs.
Any Required Cash Outlay by the Partici- pant?:	Yes, unless a net ex- ercise feature is im- plemented. An alternative design feature is for the Company to loan the employee money to help him or her fi- nance the exercise. To comply with appli- cable federal income tax laws, the loan would have to be structured to be at least 50% recourse vis-àvis the em- ployee.	Same as ISOs.	Generally no, though a payment equal to par value could be re- quired under the Company's Articles of Incorporation or Bylaws.	Generally no.
TAX RAMIFICATIONS:				
Date of Grant (Employee):	No federal income tax consequence to the optionee or the Company.	Same as ISOs.	No federal income tax consequence to the participant or the Company unless the participant timely filed an 83(b) election within 30 days from the date the RSA was granted to him or her. If instead the partici- pant timely filed an 83(b) election, then the participant would recognize ordinary taxable income equal to the difference be- tween the FMV of the shares on the date of grant and the price paid, if any. The Company would then have a correspond-	Assuming there is a vesting schedule, no federal income tax to the participant on the date of grant.

			ing withholding obli-	
			gation and a corre- sponding compensa- tion deduction.	
Date of Vesting (Employee):	No federal income tax consequence to the optionee or the Company.	Same as ISOs.	If no 83(b) election was timely filed within 30 days from the date of grant, the partici- pant would have compensation in- come (taxed at ordi- nary rates) equal to the difference be- tween the FMV of the shares on the date of vesting and the price paid, if any. The Company would have a correspond- ing withholding obli- gation and a corre- sponding compensa- tion deduction. If instead the partici- pant timely filed an 83(b) election, then vesting would trigger no federal income tax consequence to the participant or the Company.	Absent a deferral ar- rangement, a partici- pant holding RSUs would have compen- sation income (taxed at ordinary rates) equal to the differ- ence between the FMV of the award on the date of vesting and the price paid, if any. Absent a deferral ar- rangement, a partici- pant holding SARs would have compen- sation income (taxed at ordinary rates) equal to the differ- ence between the FMV of the award on the date of vesting and the strike price. The Company would have a correspond- ing withholding obli- gation and a corre- sponding compensa- tion deduction.
Date of Exercise (Employee):	No federal income tax consequence to the optionee or the Company. However, the "spread" under an ISO – i.e., the differ- ence between the FMV of the shares at exercise and the ex- ercise price – would be classified as an item of adjustment in the year of exercise for purposes of AMT. In order to avoid the application of AMT, the optionee would have to sell the un- derlying shares dur- ing the same calen- dar year that the ISOs were exer- cised. However, such a sale within the same calendar year	The optionee would have compensation income (taxed at or- dinary rates) equal to the difference be- tween the option's exercise price and the FMV of the un- derlying shares on the date of exercise. The Company would have a correspond- ing withholding obli- gation and a corre- sponding compensa- tion deduction.	Not an applicable concept within most designs.	Not an applicable concept with respect to most designs.

		would constitute a "disqualifying dispo-			
		sition" (defined be- low).			
		The Company would have no withholding			
		obligation and would not be entitled to any compensation de-			
		duction.			
Date of Sal ployee):	le (Em-	The tax conse- quences depend upon whether the sale is a "disqualify- ing disposition" (i.e., no disqualifying dis- position if the stock is held for at least: (i) 2	Any gain or loss would be short- or long-term capital gain or loss, depend- ing upon whether the shares were held for one year following exercise.	Same as NSOs with respect to the one- year holding period.	Assuming the RSU/SAR is settled in stock, the answer is the same as NSOs with respect to the one-year holding pe- riod.
		years from the date of grant AND (ii) 1 year from the date of exercise).			Not an applicable concept if the RSU/SAR is settled in cash.
		If the sale is not a dis- qualifying disposi- tion, then the op- tionee would recog- nize long-term capi- tal gain (or loss) equal to the differ- ence between the sale price of the shares and the exer- cise price. The Com- pany would have no corresponding with- holding obligation and would not be en- titled to any corre- sponding deduction. If instead the sale is a disqualifying dispo- sition, the optionee			
		would generally have compensation in- come (taxed at ordi- nary rates) equal to the			
		difference between the exercise price and the FMV of the underlying stock at the time of exercise (and the			
		Company would be entitled to a corre- sponding deduction).			

	Such compensation			
	income would be			
	added to the stock's			
	basis to determine			
	any capital			
CERTAIN DESIGN FEATURES:				
Vesting Provisions:	A time-based or per-	Same as ISOs.	Same as ISOs ex-	SARs have similar
	formancebased vest- ing schedule could be used, or both. In setting the vesting schedule, considera- tion should be given to the recognition of compensation ex- pense pursuant to a Black Scholes for- mula, and whether the vesting schedule should be set to help reduce the "fair value" of the award as of the date of grant (thus reducing the amount of com-		cept that the fair value of an RSA would be equal to the FMV of the award on the date of grant and the vesting schedule would affect the pe- riod over which the compensation ex- pense would be rec- ognized.	considerations as ISOs, and RSUs have similar consid- erations as RSAs.
Termination Provi-	pensation expense recognized over time). If a performance- based vesting sched- ule is used that con- tains a "market con- dition," then a Monte Carlo simulation (in- stead of a Black Scholes formula) will be used to determine the fair value of the award and any re- sulting compensation expense.	Same as ISOs.	Same as ISOs ex-	Same as ISOs ex-
Termination Provi- sions:	Upon a termination, all unvested equity would be immedi- ately forfeited. Alternatively, the op- tion could be struc- tured so that vesting is partially or fully ac- celerated if: (i) the optionee's employ- ment is terminated by the optionee for "good reason," (ii) the optionee's em- ployment is termi- nated by the Com- pany for a reason other than "cause,"	Same as ISOs.	Same as ISOs, ex- cept for the exercise element.	Same as ISOs, ex- cept that no equity re- purchase concept would apply if the RSU/SAR is settled in cash, however, a clawback of cash proceeds could be implemented.

in control transaction is consummated. Ad- ditionally, the accel- eration of vesting upon disability and/or death is a possible design feature. Image: State S			1	1	
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	To create a disquali-		
	fying disposition so		
	that the optionee and		
	Company owe less in		
	employment taxes		
	(which in turn gener-		
	ally results in share-		
	holders receiving		
	more sale proceeds),		
	a design feature is to		
	-		
	require an automatic		
	exercise prior to con-		
	summation of the		
	change in control.		
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	As another design		
	feature, an automatic		
	cash-out feature		
	could be imple-		
	mented for all vested		
	but unexercised op-		
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Initial Public Offering:	Consider whether to		
	have vesting acceler-		
	ated upon the effec-		
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	Registration State-		
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	ment or upon a re-		
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	tion.		
	Consider whether,		
	upon the occurrence		
	of an IPO, an op-		
	tionee should have		
	co-registration rights		
	so that he or she can		
	sell his or her pro rata		
	shares in the open		
	market to the extent		
	other shareholders of		
	the Company are		
	participating in the		
	IPO by selling		
1	shares.		
	shares.		

Are there any tax advantages for an employee if the revenues based on the equity investment are reinvested in start-ups or other companies?

Hunton AK response: just that the value of the equity increases, thus such value can be captured at long-term capital gains rates if structured correctly.

Are there any tax advantages for the company if an ESOP is established in the company?

Hunton AK response: not really. the company gets a compensatory deduction at some point

in the life cycle of the equity award. see attached chart.

Please highlight one pro and one con of the legal set up with regard to ESOPs in your jurisdiction.

Hunton AK response: one pro is the incentive and retention aspects of equity awards. the cons would be the governance and dilution associated with the same.