

The DO's and DON'Ts of Equity in a Start Up

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Agenda

- Terminology
- Review of commonly used equity oriented compensation plans
 - Incentive Stock Options (ISO's)
 - Nonqualified Stock Options (NQSO's)
 - Restricted Stock
- Section 83(b) election
- Common Do's and Don'ts
- Other equity based compensation plans

Terminology

- Stock Option – a contractual right granted to an employee to purchase shares of the employer’s stock in the future in accordance with a specified plan.
- Grant Date – the date on which an employee receives a stock option.
- Vesting Date – date on which an employee has the right of ownership for the stock option.
- Exercise Date – the date shares are purchased.
- Exercise Price – The price at which the stock option may be purchased for.
- Sales Date – The date when exercised options are sold
- Expiration Date- The date when the option will expire.
- IRC Sec. 83b – election, which the recipient of restricted stock may elect, to include in his gross income the FMV of the shares on the date of grant.
- IRC 409 A - Adopts a broad definition of nonqualified compensation.

Incentive Stock Options

Requirements

1. The option is granted pursuant to a plan.
2. The option is granted within 10 years of adoption or shareholder approval.
3. The exercise price equals or exceeds the fair market value at the time the option is granted.
4. The option is nontransferable
5. The option is granted to an employee who owns no more than 10% of the Corporation.

Incentive Stock Options

Requirements (continued)

6. The total FMV of options first exercisable by any grantee during a calendar year does not exceed \$100,000.
7. The option must be granted to an employee of:
 - (1) the granting corporation
 - (2) a parent or subsidiary of the granting corporation
 - (3) a corporation that assumes the options pursuant to a merger, consolidation, acquisition or property or stock, reorganization or liquidation, under Section 424(a) of the Internal Revenue Code.

Nonqualified Stock Options

- A stock option that does not meet the requirements of an incentive stock option.
- The employee is taxed when the option is exercised.

Planning for Income Recognition upon Receipt of NQSO's

4-Step Analysis:

1. Consider the tax impact at the Grant Date
2. Tax substantially vested stock at the Exercise Date
3. Defer tax on Restricted Stock until Substantially Vested
4. Consider a Section 83(b) Election on Restricted Stock upon exercise date

Stock Option Example

■ ISO:

An employee is granted an ISO on March 1st 2010 to purchase 1,000 shares in his/her company for \$10/share, the current market price of the stock. The option is redeemable one year from the grant date and expires March 1st 2020

■ NQSO:

Same as above, however the NQSO is granted at a discounted rate of \$8/share.

For both examples assume the employee exercises his/her option for all 1,000 shares on July 1, 2011 when the shares are trading at \$15/share.

Stock Option Example (continued)

	<u>ISO</u>	<u>NQSO</u>
Grant Date March 1, 2010 Option to purchase 1,000 shares	No tax consequences.	No tax consequences. (Assuming option is not traded on a securities exchange)
Exercise Date July 1, 2011 Purchase 1,000 shares FMV = \$15/share	No tax consequences for regular tax. (AMT tax possible).	Recognize income equal to excess of FMV of stock over option price. In this case \$7,000 (($\$15 - \8)*1,000). Taxed at ordinary income rates. (Assume stock received is substantially vested)
Taxation upon Sale	Disqualifying disposition = ordinary income (Sale within two years of grant date or one year of exercise date) OR Capital gain	Capital gain

Restricted Stock

- A grant of company stock in which the recipient's rights in the stock are restricted until the shares vest. (i.e. restricted stock are subject to forfeiture risk)
- The Company can transfer its stock at no cost to its employees.
- Consider Section 83(b) election

Section 83(b) Election

- **Definition:** When an employee receives restricted stock, a decision must be made on whether to pay taxes on the restricted stock at its current value in the year in which the stock was received, rather than when it vests. This election must be made within 30 days of receiving the stock.

83(b) Election (continued)

- YES – election *for* 83(b): The employee recognizes income on the date of receipt and pays tax on the compensation amount of the stock received. He/she then pays capital gains tax on the stock when it is sold.
- NO – election *against* 83(b): The employee will pay tax at ordinary income tax rates on the date the time restrictions lapse. This tax will be higher assuming that the stock has appreciated.

83(b) Election - Example

- In return for services, you receive 5,000 shares of restricted stock in a startup company when the shares are worth \$1.00. Shortly thereafter the company goes public and is extremely successful. When the shares vest three years from now, they are trading at \$60.
 - If you chose not to elect 83(b), you report nothing when you receive the shares, but report \$300,000 of ordinary income (not capital gain) when the shares vest. You may pay close to \$120,000 in federal income tax as a result.
 - If you elect to take 83(b), you would report \$5,000 of ordinary income when you make the election. You do not report income at the time the stock vests. If you sell the stock for \$300,000 after holding it for more than a year you'll report \$295,000 of long-term capital gain and be taxed at a much lower rate saving you approximately \$80,000 in taxes.

83(b) Election Summary

- The section 83(b) election makes sense in the following situations:
 - The amount of income you'll report when you make the election is small and the potential for growth in value of the stock is great
 - You expect reasonable growth in the value of the stock and the likelihood of a forfeiture is very small
- Conversely, you should avoid the section 83(b) election where a forfeiture is likely or where you'll pay a great deal of tax at the time of the election with only modest prospects of growth in the stock's value

Sample of an 83(b) Election form:

Sample Election

__[Date]_____

Internal Revenue Service

__[Location]_____ Service Center

__[Address]_____

The undersigned hereby elects, under IRC Sec. 83(b) to include in gross income, as compensation for services, the excess of the fair market value (at the time of transfer) of property received over the amount paid for the property.

The information required to make this election pursuant to Reg. 1.83-2(e) is as follows:

1. Taxpayer name: _____
a. Taxpayer address: _____
b. Taxpayer Identification No.: _____

2. Description of property with respect to which the election is being made:

a. Date on which property was transferred: _____
b. Tax year for which the election is being made: _____

3. Nature of restrictions or risks of forfeiture to which the property is subject:

4. Fair market value of property at time of transfer (determined without regard to any lapse restriction):
\$_____.

5. Amount paid by taxpayer for the property: \$_____

6. Copies of this statement have been furnished to the following person(s) as required by Reg. 1.83-2(d):

Signed: _____
Taxpayer

Date

Common Do's and Don'ts

- Record Keeping
- Stock for Service
 - Reporting & Recording
- AMT tax preference item upon exercising ISO
- Understanding the Deferred Compensation Plan Document
- Dilution
- Different Classes of Stock

Other Executive Compensation:

Options that do not Dilute Ownership

- Equity oriented plans paid in cash
 - Stock Appreciation Rights
 - Phantom Stock Plans
- Employee Stock Purchase Plans

Type of Plan	SARs	Phantom Stock	Restricted Stock	Incentive Stock Options	Nonqualified Stock Options
Benefit Measured by	Increase in value of shares	Increase in value of shares and dividends	Increase in value of shares and dividends	Difference between option price and fair market value upon exercise	Difference between option price and fair market value upon exercise
Benefit Paid in	Cash or shares		Restricted stock	Option exercisable in stock	
Employee's income taxation	No taxation until employee receives payments; taxation depends upon payment medium		Ordinary income when stock is vested	Upon sale, capital and ordinary income as determined by special holding period rules	Upon exercise, taxation is the same as restricted stock
Employer's income taxation	No deduction until payment to employee is made and the employee includes the payment in income		No deduction until employee recognizes taxable income	Deduction for the ordinary income recognized	No deduction until employee recognizes taxable income

Thank you!

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