ACCELERATE

Choosing the right type of equity compensation for startups in technology and the life sciences

Startup companies frequently rely on equity compensation awards to attract, retain and motivate employees. To make the best use of an equity compensation program, we recommend that a startup understand the advantages and disadvantages of granting different types of equity awards.

In this article, we will provide a high-level summary of the primary advantages and disadvantages of (1) stock option and (2) restricted stock awards, which are two equity compensation award types commonly used by private companies in the technology and life sciences sectors.

Restricted stock awards

An award of restricted stock is a grant of (or right to purchase) stock that is subject to certain contractual restrictions on its ownership, typically including a company right to repurchase the stock for the recipient's original purchase price, if any, over a certain period of time. The stock vests as the repurchase right in favor of the company lapses. Restricted stock generally vests based on either the passage of time while the recipient performs services (*ie*, time-based vesting) or on the achievement of certain performance goals while the recipient performs services (*ie*, performance-based vesting).

There are generally two alternative tax treatments possible for recipients of restricted stock awards: (1) the restricted stock award is taxed as ordinary income as it vests (*ie,* wage income on the full value of the stock less any basis in the stock); or (2) the restricted stock award recipient can choose to file an Internal Revenue Code Section 83(b) election and pay taxes, if any, on the restricted stock award. If the recipient files the Section 83(b) election immediately after the stock is transferred and pays at least 100 percent of the fair market value of the shares, then there should be no taxable income.

Advantages of using restricted stock awards

1. As a general matter, restricted stock awards will almost always have some economic value for the service provider.
2. As described above, restricted stock awards provide the ability to limit ordinary income tax by having the recipient (a) pay for the underlying shares at the time of grant and (b) file a Section 83(b) election within 30 days after the shares are transferred. Any future gain or loss recognized from selling the stock will be taxed as capital gain or loss.
3. Unlike stock options, restricted stock awards may entitle the recipient to receive dividends if and when they are paid to company shareholders.
4. Restricted stock awards are generally exempt from Internal Revenue Code Section 409A (*ie,* deferred compensation tax rules).

Disadvantages of using restricted stock awards

1. Because a restricted stock award is a "full value" award that generally always has some economic value, restricted stock rewards retention (*ie,* vesting) more than it rewards driving the company's value higher as reflected in the

company's stock price.
2. Restricted stock purchase awards must have a limited period of time for the recipient to purchase the underlying shares (*eg,* 30 days after grant).
3. A restricted stock purchase award will require a capital commitment by the recipient (*ie,* to pay the purchase price) soon after grant, which is a personal decision with unpredictable outcomes when dealing with private company stock that is illiquid. In addition, if the recipient forfeits restricted stock after making a Section 83(b) election, the recipient be unable to recapture any tax paid as a result of the election.
4. The opportunity for a holder of restricted stock to make a Section 83(b) election (within 30 days of the transfer of shares) is a strict rule that can lead to a significant tax mistake if the deadline is not met.
5. Any purchase price requirement and the tax impact of restricted stock may be impediments that are impossible to overcome if the value of the underlying shares is very high.

Stock options

A stock option gives the recipient the right to purchase a designated number of shares of stock at a fixed price at the end of a specified vesting period. The exercise price is typically the fair market value of a common share of stock at the time the option is granted. Vesting of stock options is commonly time-based (and can be, although less often is, performance-based).

Stock options are classified for tax purposes as either (1) non-statutory stock options (NSOs) or (2) incentive stock options (ISOs). The tax treatment of a stock option depends on the classification of the option as an NSO or ISO. Unlike NSOs, ISOs may only be granted to employees. If the required holding period requirement is met and if a taxpayer is not subject to the alternative minimum tax (AMT), an ISO holder does not recognize income when ISOs are exercised; instead, taxes are imposed when the ISO shares are sold. NSOs are generally taxed when exercised.

Advantages of using stock options

1. The recipient may choose when to exercise the stock option during the term of the award. This provides the recipient more control as to when he or she pays the exercise price for the underlying shares and, if applicable, when he or she owes taxes.
2. From an employer perspective, stock options are generally thought of as a better incentive device because, unlike restricted stock awards, stock options only reward the recipient if there is an increase in the company's stock price after the date of grant.
3. Unlike restricted stock, if the value of the underlying shares subject to the option is very high, the stock option is still a potentially incentivizing equity award if the parties believe that the value can go higher because the recipient does not need to make a high-risk financial commitment to the award (*ie,* pay a purchase price immediately after grant or pay taxes upon vesting).

Disadvantages of using stock options

1. A stock option generally must have an exercise price that is not less than 100 percent of the fair market value of a share on the date of grant, otherwise adverse tax and accounting impacts apply to the individual and the company. For this reason, there are greater pressures to set the exercise price of stock options correctly and to routinely obtain valuation reports to set the exercise price of stock option grants.
2. Options can be subject to the deferred compensation tax rules of IRC Section 409A. A complex set of regulations

govern the stock option, which, if not complied with, may trigger significant penalty taxes.
3. Stock options, especially ISOs, are more complex to administer than restricted stock awards due to employment, tax and securities laws.

We hope that the summary above is helpful in clarifying the differences between stock options and restricted stock. Equity compensation is highly complex, and companies considering stock option or restricted stock grants may want to consider consulting with their legal or tax advisors before taking definitive action.
