# EQUITY INCENTIVE PLAN FAQS

## WHAT IS AN EQUITY INCENTIVE PLAN?

An Equity Incentive Plan is the allocation of shares reserved for issuance to service providers as equity compensation, also called equity awards. The reserve of shares itself is called a “Pool.” This is often called an “Option Pool” as short hand for the shares that can be issued as either options or restricted stock awards.

## WHAT IS AN EQUITY INCENTIVE PLAN FOR?

Equity compensation aligns the interests of the services providers with that of the company by giving them a stake in the company. If the company’s valuation goes up, both the company and the award recipient benefit.

Independent of serving as an incentivizing tool, Equity Incentive Plans are important for companies with an eye toward institutional investments. Investors like to see an Equity Incentive Plan in place because this locks in a cushion of shares that may be disbursed to the company’s service providers. By locking this cushion in before the investor injects cash in exchange for company shares, the investor reduces the dilution of its holdings.

## HOW DOES A COMPANY SET UP AN EQUITY INCENTIVE PLAN?

A company establishing an Equity Incentive Plan needs its Board of Director’s and stockholders’ authorization. Authorization can be obtained through a meeting or a written consent, as permitted by the company’s governing documents. Upon this authorization, the Board and shareholders also approve the size of the Pool and a set of documents, including the Equity Incentive Plan and the forms of option agreements, exercise agreements, and restricted stock award agreements. The company’s Board and stockholders may later change the Pool size and make amendments to the documents.

The term “Equity Incentive Plan” refers both to the Equity Incentive Plan document which sets out the rules and procedures of the Plan as well as the intangible structure of the company’s Plan Pool and the authority for the company to issue awards from the Plan Pool.

## HOW DOES A COMPANY ISSUE EQUITY AWARDS FROM THE EQUITY INCENTIVE PLAN?

After an Equity Incentive Plan is set up, the Company’s Board or the Equity Incentive Plan committee, if one is established, should approve each equity award issued pursuant to the Plan. With the Board’s approval, the company may then enter into an option agreement or restricted stock award agreement with the award recipient.

## WHAT KIND OF EQUITY AWARDS CAN BE ISSUED UNDER AN EQUITY INCENTIVE PLAN?

There are generally two types of awards that can be issued: (1) restricted stock and (2) stock options.

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## WHAT IS RESTRICTED STOCK?

Restricted stock awards ("RSAs") are "restricted" because the award is subject to a vesting schedule. As shares of the award vest, those shares are released from the company's option to repurchase the shares. This means that if the award recipient departs the company, the company does not have the option to repurchase those vested shares. The company would still have the option to purchase any unvested shares.

## WHAT IS VESTING?

Vesting means conditions on the release of the award. For a restricted stock award, the recipient does not own the unvested shares underlying the award free and clear until the shares are vested. For an option award, the recipient cannot exercise his or her right to purchase the shares underlying the award until the shares are vested. Absent unusual circumstances, equity awards should always be subject to vesting.

There are two types of vesting: (1) time based and (2) milestone based. Time based vesting means that the vesting is conditioned on the service provider continuing to work for the company. Milestone vesting means the release of shares is conditioned on performance goals set by the company.

## WHAT IS A STOCK OPTION?

A stock option is the right to purchase company stock at a predetermined price, known as the exercise price or strike price. Once an option recipient exercises an option share, the individual then owns that share of stock. There are two types of stock options: NQSOs and ISOs. Stock options typically vest monthly over four years.

## WHAT IS AN NQSO?

A non-qualified stock option ("NQSO") is the default type of stock option. It is "not qualified" because it does not meet the special requirements imposed by the Internal Revenue Code for special tax treatment. These are sometimes abbreviated as NSOs.

## WHAT IS AN ISO?

An incentive stock option ("ISO") is a type of stock option that meets certain Internal Revenue Code requirements for non-recognition of ordinary income. The tax treatment of ISOs and NQSOs is discussed on the following page.

## HOW IS THE EXERCISE PRICE SET?

An exercise price for an option is typically set by a third-party valuation called a "409A valuation." A 409A valuation is the evaluation of comparable companies combined with statistical methods to derive a company's share price. A 409A valuation is typically valid for 1 year or until the occurrence of a significant company event, such as a capital raise. If a company doesn't have revenue and doesn't have valuable assets such as patents or trademarks, then the Board should determine the company's per share valuation to set an exercise price.

## HOW ARE STOCK OPTIONS AND RSAS TAXED?

### Options

Assuming that a stock option does not have a readily ascertainable fair market value and that the exercise price is determined based upon a 409A valuation of the company, there is no tax consequence as of the authorization, grant, or vesting of the options because the recipient hasn't received anything during each of those events. The recipient still has to pay the exercise price before he or she receives the stock. Only upon the exercise of the stock option is there a taxable income event. The only difference between NQSOs and ISOs is the tax treatment. This is summarized in the chart below.

### RSAs

Unlike options, RSA recipients do not have to exercise anything to receive shares. Instead, an RSA recipient receives shares of stock as the award vests. This means that the recipient receives taxable income in the form of stock upon vesting. The tax consequence for RSAs is summarized below.

| Event | NQSOs Tax Consequence | ISOs Tax Consequence | RSAs Tax Consequence |
|---|---|---|---|
| The Board authorizes the grant of the award. | – | – | – |
| The company grants the award. | – | – | *If an RSA is not subject to a vesting schedule, then the full fair market value of the award is taxable for the recipient upon grant. (See "83(b) election") |
| Shares of the award vest. | – | – | The fair market value of the vested award is taxable income for the recipient. |
| The recipient exercises shares of the option. | To the extent the fair market value of the company shares exceeds the exercise price, that difference is taxable to the recipient as ordinary income. | There are no tax consequences even if the fair market value of the company's shares exceeds the exercise price of the option. This is the tax benefit conferred by ISOs. | N/A |
| The recipient sells the shares that he or she purchased through the option exercise/received via an RSA. | To the extent the recipient makes a profit on the sale, this will be taxed as capital gains. | To the extent the recipient makes a profit on the sale, this will be taxed as capital gains. | To the extent the recipient makes a profit on the sale, this will be taxed as capital gains. |

* "Readily ascertainable fair market value" is a term of art. An option has a readily ascertainable value if either (1) the option is actively traded on an established market or (2) the option meets all of these conditions: (i) the option is transferable by the recipient; (ii) the option is fully exercisable immediately; (iii) the option or the stock underlying the option is not subject to any restrictions having a significant effect on the option's fair market value; and (iv) the fair market value of the option privilege is readily ascertainable.

## WHAT IS AN 83(B) ELECTION?

An 83(b) election is an election that the recipient makes with the IRS that allows for the recipient to pay taxes based upon the fair market value of the stock as of the date of issuance. The reason the 83(b) election can be a powerful tool for RSAs is because it shifts the timing of the ordinary income tax treatment to the date of issuance of the award as opposed to the vesting of the award.

### *An example is helpful:*

A new pre-revenue startup wants to attract an Advisor by issuing 100 shares of common stock via an RSA. Because the startup is pre-revenue and hasn't raised any money from investors yet, the value of a share of common stock is still at the par value of $0.00001. For this example, we will assume the Advisor's income is taxable at an ordinary income tax rate of 37% and a capital gains tax rate of 20%.

If the Advisor makes a timely 83(b) election, then the ordinary income for the advisor would be 10,000 x $0.00001 = $0.10. The Advisor pays $0.10 x 37% = $0.04 in ordinary income taxes. The startup is a major success and a share of Common Stock is later worth $50.00. When the Advisor sells the shares, the Advisor would need to pay capital gains tax on $500,000 - $0.10 = $499,999.90. The Advisor's capital gains tax owed would be $499,999.90 x 20% = $99,999.98. The total tax paid in this scenario is $100,000.02.

Roll back the clock and imagine the Advisor did not make the 83(b) election. Let's assume for simplicity that all 10,000 of the Advisor's shares vest in the year that the shares are worth $50.00 each. Now, the Advisor will have to pay the higher ordinary income tax on 10,000 x $50.00 = $500,000. The Advisor owes ordinary income tax of $500,000 x 37% = $185,000. Only when the Advisor later sells the shares would the capital gains tax rate of 20% come in to play. If the Advisor turns around immediately to sell the shares for $500,000, then the capital gains tax owed would be $500,000 - $500,000 = $0.

As you can see, the 83(b) election can be a powerful tool to shift the timing of the ordinary income tax and capital gains tax treatment. This chart demonstrates the Advisor example we walked through:

| | Date of Issuance (Year Y) | Date of Vesting (Year Z) | Date of Sale of Shares (Year Z) | Total Taxes |
|---|---|---|---|---|
| **Taxes Owed If 83(b) Election Made** | $0.10 x 37% = $0.04 | None | $499,999.90 x 20% = $99,999.98 | **$100,000.02** |
| **Taxes Owed If 83(b) Election Not Made** | None | $500,000 x 37% = $185,000 | $500,000 - $500,000 = $0 | **$185,000.00** |

Of course, where the IRS giveth, the IRS also taketh. The catch with 83(b) elections is that the recipient pays taxes up front even though the shares are subject to a substantial risk of forfeiture. So what happens if the recipient doesn't end up receiving the shares? Tough luck, because the recipient will have already paid the taxes associated with the RSA. With that being said, it will still most likely make sense for recipients to make the 83(b) election where the company's valuation is at par value or relatively low compared to the expected valuation as the shares vest.

## HOW DO RECIPIENTS MAKE AN 83(B) ELECTION?

A complete RSA form will include an 83(b) election form that makes it easy for recipients to make the election. The election must be made within 30 days of the issuance of the stock. Be careful with the timing as it is exceedingly rare for the IRS Commissioner to grant an exception to this 30-day deadline.

## WHAT HAPPENS TO SHARES OF AN AWARD THAT DON'T VEST?

The unvested shares automatically go back to the Equity Incentive Plan's Pool of reserved stock. There is no action needed on the part of the company because this mechanism is written into a well-drafted Equity Incentive Plan.