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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 appreciatiion 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 Appreciation Right
GENERAL CHARACTERISTICS:				
Value of Award:	Appreciation-only award. This means the participant receives the difference between the exercise price and the FMV of the underlying stock as of the date the underlying stock is sold.	Same as ISOs.	Full-value award. This means the participant receives the difference between $0.00 and the FMV of the underlying stock as of the date the underlying 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 discretion of the Company. However, equity classification for accounting purposes (which is typically desired) cannot be maintained if the award is to be settled 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 purposes).
Impact on Shareholder Dilution:	Compared to full-value awards, ISOs are more dilutive because, due to the "at the money" strike price associated with the grant of an ISO, more shares are typically required in order for the recipient to have a stated level of perceived value.	Same as ISOs.	Compared to appreciationonly awards, RSAs are less dilutive (assuming any purchase element is $0.00 or par value) because, as a full value award, RSAs have a direct correlation between the FMV of the award on the date of grant and the perceived value of the RSA by the recipient.	No equity dilution if the RSU/SAR is settled 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 Participant?:	Yes, unless a net exercise feature is implemented. An alternative design feature is for the Company to loan the employee money to help him or her finance the exercise. To comply with applicable federal income tax laws, the loan would have to be structured to be at least 50% recourse vis-àvis the employee.	Same as ISOs.	Generally no, though a payment equal to par value could be required 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 participant timely filed an 83(b) election, then the participant would recognize ordinary taxable income equal to the difference between 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 obligation and a corresponding compensation 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 participant would have compensation income (taxed at ordinary rates) equal to the difference between the FMV of the shares on the date of vesting and the price paid, if any. The Company would have a corresponding withholding obligation and a corresponding compensation deduction. If instead the participant timely filed an 83(b) election, then vesting would trigger no federal income tax consequence to the participant or the Company.	Absent a deferral arrangement, a participant holding RSUs would have compensation income (taxed at ordinary rates) equal to the difference between the FMV of the award on the date of vesting and the price paid, if any. Absent a deferral arrangement, a participant holding SARs would have compensation income (taxed at ordinary rates) equal to the difference between the FMV of the award on the date of vesting and the strike price. The Company would have a corresponding withholding obligation and a corresponding compensation 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 difference between the FMV of the shares at exercise and the exercise 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 underlying shares during the same calendar year that the ISOs were exercised. However, such a sale within the same calendar year	The optionee would have compensation income (taxed at ordinary rates) equal to the difference between the option's exercise price and the FMV of the underlying shares on the date of exercise. The Company would have a corresponding withholding obligation and a corresponding compensation deduction.	Not an applicable concept within most designs.	Not an applicable concept with respect to most designs.

	would constitute a "disqualifying disposition" (defined below). The Company would have no withholding obligation and would not be entitled to any compensation deduction.			
Date of Sale (Employee):	The tax consequences depend upon whether the sale is a "disqualifying disposition" (i.e., no disqualifying disposition if the stock is held for at least: (i) 2 years from the date of grant AND (ii) 1 year from the date of exercise). If the sale is not a disqualifying disposition, then the optionee would recognize long-term capital gain (or loss) equal to the difference between the sale price of the shares and the exercise price. The Company would have no corresponding withholding obligation and would not be entitled to any corresponding deduction. If instead the sale is a disqualifying disposition, the optionee would generally have compensation income (taxed at ordinary 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 corresponding deduction).	Any gain or loss would be short- or long-term capital gain or loss, depending 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 period. Not an applicable concept if the RSU/SAR is settled in cash.

	Such compensation income would be added to the stock's basis to determine any capital			
CERTAIN DESIGN FEATURES:				
Vesting Provisions:	A time-based or performancebased vesting schedule could be used, or both. In setting the vesting schedule, consideration should be given to the recognition of compensation expense pursuant to a Black Scholes formula, 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 compensation expense recognized over time). If a performance-based vesting schedule is used that contains a "market condition," then a Monte Carlo simulation (instead of a Black Scholes formula) will be used to determine the fair value of the award and any resulting compensation expense.	Same as ISOs.	Same as ISOs except 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 period over which the compensation expense would be recognized.	SARs have similar considerations as ISOs, and RSUs have similar considerations as RSAs.
Termination Provisions:	Upon a termination, all unvested equity would be immediately forfeited. Alternatively, the option could be structured so that vesting is partially or fully accelerated if: (i) the optionee's employment is terminated by the optionee for "good reason," (ii) the optionee's employment is terminated by the Company for a reason other than "cause,"	Same as ISOs.	Same as ISOs, except for the exercise element.	Same as ISOs, except that no equity repurchase concept would apply if the RSU/SAR is settled in cash, however, a clawback of cash proceeds could be implemented.

	and/or (iii) a change in control transaction is consummated. Additionally, the acceleration of vesting upon disability and/or death is a possible design feature. Also, the option could be structured so that both unvested and vested options are forfeited for no additional consideration if the optionee is terminated for "cause." And if the option was previously exercised as of the date a termination for cause is effectuated, then the option could provide for the repurchase of the underlying stock at the lesser of: (i) the then FMV or (ii) the exercise price. Finally, the forfeiture and repurchase discussed in the above paragraph could equally be triggered if the optionee violates any non-competition or non-solicitation agreement.			
Repurchase Rights, Rights of First Refusal, Drags & Tags:	Typically these issues are addressed in the shareholders' agreement. But if no shareholders' agreement exists, or if a shareholders' agreement exists but it is desired that the optionees not participate in such agreement, then such issues are addressed in the granting documentation.	Same as ISOs.	Same as ISOs.	Same as ISOs.
Change in Control:	Generally participate in the same manner as shareholders (assuming the option is exercised).	Same as ISOs, except there would be no automatic exercise feature.	Same as NSOs.	Same as NSOs.

	To create a disqualifying disposition so that the optionee and Company owe less in employment taxes (which in turn generally results in shareholders receiving more sale proceeds), a design feature is to require an automatic exercise prior to consummation of the change in control. As another design feature, an automatic cash-out feature could be implemented for all vested but unexercised options.			
Initial Public Offering:	Consider whether to have vesting accelerated upon the effectiveness of an S-1 Registration Statement or upon a reverse merger into a public shell corporation. Consider whether, upon the occurrence of an IPO, an optionee 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 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.