Choosing the Right Type of Equity Compensation for Start-up Company Employees

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This Note provides an overview of the types of equity compensation awards commonly used by start-up companies and an explanation of the reasons why certain types of awards are used at various stages of development. This Note discusses the basic characteristics, federal tax consequences, accounting treatment and advantages and disadvantages of granting these types of equity awards.

This Note provides an overview of different types of equity awards commonly used by start-up companies and an explanation of the reasons why certain types of awards are used at various stages of development.

Grants of equity compensation provide an excellent opportunity for employees to earn additional income beyond salary and to acquire an ownership interest in the company. Equity compensation can be particularly useful to a start-up company, which may not have the cash necessary to adequately attract, retain and motivate employees with market-rate salaries. In certain industries, it is standard practice for a start-up company to include equity as a part of every employee's compensation package.

To make the best use of an equity compensation program, a start-up company must understand the legal implications, tax consequences and accounting treatment of granting each type of equity award. A start-up company could face personnel issues and public relations problems if, as a result of not understanding the tax consequences of granting a certain type of award, it causes its employees tax problems that may have been avoided by using a different type of equity award.

This Note:

- Discusses the basic characteristics, federal tax consequences, accounting treatment and advantages and disadvantages of granting the following types of equity compensation awards:
  - restricted stock;
  - stock options; and
  - restricted stock units (RSUs).
- Describes the types of equity awards typically used by a start-up company at each stage of its development.
- Highlights other issues a start-up company should consider when granting equity, including appropriate valuation methods.

In considering the best equity compensation approach for a start-up company, this Note considers two different start-up company scenarios:

- A typical success story, where the stock price of the start-up company is initially a nominal amount ($0.001 per share), which rises gradually over time as the company develops its product, finds its market and begins to bring in revenue, until finally the company is cash-flow break-even and achieves a liquidity event, in the form of an acquisition or an initial public offering, at which time the employee equity holders are either cashed out (in the case of an acquisition) or can choose to sell their equity awards in a public market for a price greater than the price the employee paid for the shares. Other liquidity scenarios are possible, but are not considered in this Note.
- A typical story of failure, where the common stock of the start-up company becomes worthless and the start-up company is abandoned. Although not a happy fate, an employee must consider this outcome when deciding on the potential value of equity compensation.

This Note assumes that until a liquidity event occurs, and in some instances, for a certain period of time after the liquidity event, the holder of the equity award has no way to liquidate the award or a portion of the award to pay taxes that become due on the award because:

- The start-up company's stock is subject to resale restrictions and is not publicly traded (and, therefore, no public market for the stock exists).
- The start-up company's stock is subject to restrictions on transfer detailed in an award agreement, federal or state securities laws, the company's bylaws or a stockholder agreement to which the holder is a party. Many private companies restrict any transfer of shares acquired under employee plans to:
  - avoid acquiring a hostile stockholder;
  - prevent access to financial or other proprietary information that must be made available to stockholders; and
  - avoid the business disruption that can ensue when private company shares are traded on the types of private markets that have been created in recent years, such as SecondMarket.

  For more information on transfer restrictions that are applicable in the private equity context, and that are sometimes seen in the start-up space, see *Practice Note, Management Equity Incentives: Rights and Restrictions, Transfer Restrictions (http://us.practicallaw.com/2-500-6213#a319069)*.
- If the start-up company goes public, a market stand-off or lock-up will apply (usually during the six-month period after an effective registration statement is filed under the Securities Act of 1933) during which the sale of shares awarded under the employee equity plan will be prohibited.

This Note is limited to the topic of how a start-up company can choose the right type of equity award and does not discuss how to determine:

- Which employees are eligible to receive equity awards.
- At which stage or stages of employment an employee should receive equity grants (for example, at hiring or based on performance).
- The amount of equity that should be:
  - made available for awards under the equity plan; and
  - awarded to each individual employee.

RESTRICTED STOCK

Restricted stock is stock that is subject to certain contractual restrictions on its ownership, typically including:

- Restrictions on transfer or resale.
- The company's right to repurchase the stock for a certain period of time after the employee's termination of employment. These restrictions remain in place until the restricted stock vests, based on the employee's continuous employment. A vesting period typically used by a start-up company is four or five years with a one-year cliff, followed by ratable monthly vesting. For example, restricted stock that vests over a four-year period with a one-year cliff vests as follows: a quarter of the restricted stock vests one year after the grant date, and 1/48th of the restricted stock vests each month thereafter. If the employee's employment terminates before the end of the vesting period, the company may exercise its repurchase right within a certain period of time following the employee's termination of employment (typically 90 days).
- The repurchase price for unvested shares is typically the original cost of the equity or, in some instances (such as a termination for cause), the lower of the original cost of the equity or the fair market value of the shares on the date of termination.
- In unusual circumstances, vested shares can also be subject to repurchase and the repurchase price can vary depending on the circumstances surrounding the employee's termination of employment. If the employee is terminated for cause, the repurchase price is typically the lower of the original cost of the equity or the fair market value of the shares on the date of termination. Where vested shares are subject to repurchase in case of a resignation or termination without cause, the repurchase price would typically be the fair market value of the shares.

The vesting requirement is important because it creates a strong incentive for an employee to remain with the company.

FEDERAL TAX CONSEQUENCES

On the date restricted stock is granted, the employee becomes the owner of record of the restricted stock. For federal tax purposes, the employee who acquires restricted stock as compensation is subject to Section 83 of the Internal Revenue Code (IRC). For more information about IRC Section 83 and the transfer of property, see *Practice Note, Overview of the Taxation of Equity Compensation Awards, Section 83 and the Transfer of Property (http://us.practicallaw.com/7-505-9204#a596426)*.

Unless the employee files a Section 83(b) election (described below), the employee is not taxed on the grant date. However, in the year the restricted stock vests, the employee must include as ordinary income the excess of the fair market value of the stock on the date of vesting over the amount paid for the stock on the grant date, if any. For a start-up company employee, paying tax as the shares vest may prove to be an insurmountable financial obligation, assuming that the value of the shares increases over time.

For example, assume an employee is awarded 300,000 shares of restricted stock in consideration of services with a grant date fair market value of $0.03 per share and a four-year vesting schedule with annual vesting (although, as described above, a one-year cliff with ratable monthly vesting after the cliff is more typical). If the stock price is $10.00 per share when the first 25% installment vests after one year of employment, those shares would be worth $750,000 (300,000 shares x 0.25 x $10.00) and the employee would be required to recognize that amount in ordinary income (assuming the employee did not pay anything for the shares when they were granted). After one more year of vesting, if the stock price is $20.00 per share, then those additional 75,000 shares would be worth $1,500,000 (300,000 shares x 0.25 x $20.00) and the employee would be required to recognize that amount in ordinary income. If the employee cannot sell the shares as the shares vest (due to transfer restrictions and lack of a market) to cover the cost of the taxes, then the inclusion of income in these amounts could prove to be a significant financial burden to the employee.

To avoid this outcome, the employee could file, within 30 days of transfer of the restricted stock, a Section 83(b) election with the Internal Revenue Service (IRS). If the employee timely files a Section 83(b) election, the employee recognizes ordinary income in the year of grant in an amount equal to the excess of the grant date fair market value of the stock over the purchase price paid for the stock, if any. If the employee pays the grant date fair market value for the stock and timely files a Section 83(b) election, no ordinary income would be realized as of the grant date and any future gain or loss recognized from selling the stock would be capital gain or loss. If the shares are held for more than 12 months, the employee may be eligible for long-term capital gain treatment. For an example of a Section 83(b) election, see *Standard Document, Internal Revenue Code Section 83(b) Election: Restricted Stock (http://us.practicallaw.com/3-518-4832)*.

The company is generally entitled to a tax deduction in the amount, and at the time, the employee recognizes ordinary income. Therefore, if an employee files a Section 83(b) election, the employer can deduct the award as a compensation expense at the time of grant, rather than waiting until vesting.

Restricted stock awards constitute remuneration for services and are treated as wages subject to tax withholding by the company. If an employee does not file a Section 83(b) election, on each vesting date the company must collect income and employment taxes and remit those taxes to the IRS and any state tax authority. If an employer does not receive proof that the employee timely filed a Section 83(b) election, it must report and withhold as though a Section 83(b) election had not been made. For more information on the taxation of restricted stock, see *Practice Note, Overview of the Taxation of Equity Compensation Awards: Restricted Stock (http://us.practicallaw.com/7-505-9204#a790461)*.

ACCOUNTING TREATMENT

Assuming the typical vesting provisions used by a start-up company described earlier, the grant date fair value of the restricted stock (less any value paid for the shares) generally must be reflected as a compensation expense for financial accounting purposes and expensed over the expected vesting period. For more information about the accounting treatment of equity compensation awards, see *Practice Note, Drafting an Equity Incentive Plan for a Private Company: Accounting Considerations (http://us.practicallaw.com/9-504-0685#a911994)*.

ADVANTAGES AND DISADVANTAGES

The primary advantage of awarding restricted stock is the ability to freeze the ordinary income recognition to zero by paying the fair market value of the shares at the time of grant and filing a Section 83(b) election within 30 days after the shares are transferred to the employee in consideration of services. After properly filing a Section 83(b) election, any future gain or loss recognized from selling the stock is capital gain or loss. In addition, shares held more than 12 months may benefit from long-term capital gain treatment. Another advantage of restricted stock is that the company is not required to conduct an independent valuation when granting restricted stock (unlike when granting stock options). Although accurate reporting is important for tax purposes, it is not typical for a start-up company to engage an independent valuation to determine the value of restricted stock.

The challenge of awarding restricted stock to an employee is the employee's ability to provide the cash to either purchase the stock for fair market value (if the employee plans to file a Section 83(b) election) or to pay for income taxes recognized at the time of vesting (if the employee does not file a Section 83(b) election).

For example, if a start-up company awards an employee 300,000 shares of restricted stock, with a grant date fair market value of $0.30 per share, the employee must pay $90,000 to purchase the shares. This amount may be difficult for an employee to afford, particularly a start-up employee who may be working for a below-market salary. The company may award the shares for no cost or par value depending on state corporate law, but then the employee must pay ordinary income taxes on receipt or vesting of the shares, as applicable. In the example above, the employee's tax bill on receipt of $90,000 worth of shares (assuming the employee files a Section 83(b) election discussed above) would be approximately $40,000 (depending on state taxes and other factors). Receiving "free" stock is therefore still prohibitive for many start-up employees. An employee must be able to provide cash either to buy the shares or pay the taxes.

COMMON USAGE

Restricted stock is most commonly awarded to a start-up company's founders or during the initial start-up phase of a company. Founders and other initial employees of the company typically buy restricted stock for a nominal cost, because the value of the shares is exceedingly low when the company is just being formed. At a later stage, the common stock value is typically higher and, even if still low per share, an employee may not be able to afford to purchase the shares for their fair market value. Even if the employee can afford to purchase the restricted stock for fair market value the employee incurs an immediate cash cost, which puts the purchase money at risk of potential loss, and purchasing the stock eliminates the employee's ability to use the purchase money for other investments (that is, the employee incurs an opportunity cost in purchasing the restricted stock).

In certain limited instances, a start-up company may award restricted stock to an employee at a later stage of development. For example, a company recruiting a high level executive may award the executive restricted stock at no cost to the executive. Although the executive must pay taxes for the receipt of the free stock, this is attractive to the executive because the executive can benefit from long-term capital gain treatment.

STOCK OPTIONS

A stock option gives the holder (the optionee) the right to purchase a designated number of shares of stock at a fixed exercise price at the end of a specified vesting period. Even if the fair market value of the stock rises after the stock option is granted, the optionee may purchase the stock at the fixed exercise price set at grant and reflected in the stock option agreement. Stock options must be granted with an exercise price at least equal to the fair market value of a share on the grant date to be exempt from Section 409A, which is necessary to give the optionee the flexibility to exercise the option when the optionee chooses. Because the stock of a start-up company is not readily tradeable on an established market, determining the fair market value of a share of stock on any given date must be done in accordance with Section 409A for the stock option to be exempt from Section 409A (see *Section 409A and Valuation Issues*).

Stock options typically become exercisable in installments over a period of time, provided the optionee continues to render services to the company. Options typically expire five to ten years after the grant date or earlier on separation from service with the employer.

These awards are called stock options because the optionee has the choice to buy the stock for its specified exercise price or to refrain from buying the stock at its specified exercise price. The optionee bears no investment risk unless and until the optionee exercises the stock option and buys the stock.

From a tax perspective, an option has three important events in its lifecycle. The first event occurs when a company awards the stock option. This is called the option grant. The second event occurs when the optionee purchases the optioned stock from the company at the guaranteed price. This is called the option exercise. The third event occurs when the stockholder sells the stock or transfers the stock to another person. This is called the sale.

NON-QUALIFIED STOCK OPTIONS

A non-qualified stock option (sometimes called a non-statutory stock option) is any stock option, other than an incentive stock option (see *Incentive Stock Options*), that is granted to a person in connection with the performance of services. Non-qualified stock options may be granted to employees, independent contractors and non-employee directors.

Federal Tax Consequences

A non-qualified stock option is not taxed at grant or when it vests. However, as with restricted stock, the purchase of stock on the exercise of a non-qualified stock option is subject to IRC Section 83. Therefore, an optionee who exercises a non-qualified stock option to purchase stock that is vested at the time of exercise is taxed at ordinary income tax rates on the excess, if any, of the fair market value of the stock on the date of exercise over the exercise price paid for the stock (the "spread") and the employer is obligated to withhold taxes based on this spread. The optionee's capital gains holding period begins on the date of exercise.

Although relatively uncommon outside of the start-up space, some start-up companies choose to grant options to purchase stock that is not vested. These awards are sometimes referred to as early exercise options or California style options. If the stock is not vested at the time of exercise (for example, if the stock remains subject to the company's right to repurchase the stock for the original cost of the equity if the optionee's employment is terminated) both taxation and the commencement of the capital gains holding period are deferred until the date the stock vests, unless the optionee files a Section 83(b) election within 30 days of exercise. If the optionee timely files a Section 83(b) election:

- The optionee includes as ordinary income in the year of exercise the excess of the fair market value of the stock purchased on the exercise date over the exercise price paid for the stock.
- No additional income is recognized when the stock eventually vests.
- The capital gains holding period begins on the exercise date.

Accounting Treatment

Assuming the typical vesting provisions used by a start-up company described earlier, the fair value of a non-qualified stock option (including an early exercise option) granted to an employee generally must be reflected as a compensation expense for financial accounting purposes as of the grant date and expensed over the expected vesting period. The expense equals the fair value of the option that is granted using a recognized valuation method. For more information about the accounting treatment of equity compensation awards, see *Practice Note, Drafting an Equity Incentive Plan for a Private Company, Accounting Considerations (http://us.practicallaw.com/9-504-0685#a911994)*.

Advantages and Disadvantages

A disadvantage of a non-qualified stock option is the need for the company to either conduct or rely on a recently conducted valuation in accordance with Section 409A to grant stock options that are exempt from Section 409A. Another major disadvantage from the company's perspective is the company's obligation (if the optionee is an employee) to withhold the taxes due at ordinary income tax rates on the spread between the fair market value of the purchased stock at the time of exercise over the exercise price paid for the stock. The obligation to collect or withhold income and employment taxes can be a substantial detriment to a start-up company with limited infrastructure, since failure to withhold taxes can result in penalties for the company or for individuals within the company.

An advantage of non-qualified stock options over incentive stock options is that the exercise starts the capital gains holding period and, one year later, the optionee will have long-term capital gains treatment. For early exercise non-qualified stock options, the capital gains holding period can start as early as grant, assuming the optionee exercises the option on grant and timely files a Section 83(b) election. Non-qualified stock options also provide the company with a tax deduction that is not available with incentive stock options unless the optionee makes a disqualifying disposition (see *Federal Tax Consequences*).

Another advantage of non-qualified stock options over incentive stock options is that they may be granted to non-employee directors and independent contractors, while incentive stock options may only be granted to employees.

INCENTIVE STOCK OPTIONS

An incentive stock option (ISO) is a special type of stock option granted to a company's employees that receives favorable tax treatment if two holding periods are met and other requirements of IRC Section 422 are satisfied. For a description of the requirements for an option to qualify as an ISO, see *Incentive Stock Options Checklist (http://us.practicallaw.com/7-518-3717)*.

Federal Tax Consequences

Regular federal income tax is not due on the grant or exercise of an ISO. If the stock that is purchased is held for more than one year after the date of exercise and for more than two years after the grant date, any gain or loss on the sale or other disposition is a long-term capital gain or loss. An earlier sale or other disposition (a disqualifying disposition) disqualifies the ISO and generally results in ordinary income tax on the difference between the fair market value of the stock on the exercise date over the exercise price paid for the stock.

If an employee realizes ordinary income in connection with a disqualifying disposition, the company may take a corresponding deduction for compensation deemed paid. Most importantly, the employer has no obligation to collect employment taxes on exercise of an ISO. This also means that neither the employer nor employee pays the Federal Insurance Contributions Act (FICA) tax or the Federal Unemployment Tax Act (FUTA) tax on exercise of an ISO.

Although ordinary income tax is not due on the exercise of an ISO, the excess of the fair market value of the stock underlying an ISO on the date of exercise over the exercise price is subject to the alternative minimum tax (AMT). The AMT paid in connection with ISOs is generally creditable against future years' income tax in excess of the years' AMT.

In the dot-com boom and crash of the early 2000's, many employees were subject to the AMT on shares that they either could not sell or chose not to sell. Later, when the tax bills came due, the shares had declined in value to such an extent that the employees could not sell the shares for an amount sufficient to cover the tax bill. This uncomfortable scenario can be avoided with proper planning, but the AMT is something start-up employees fear.

An ISO (like a non-qualified stock option) may be granted as an immediately exercisable stock option subject to the employer's right of repurchase that lapses as time passes (that is, an early-exercise or California-style ISO). This type of ISO is typically granted in conjunction with the employee filing a Section 83(b) election to limit the exposure to the AMT. However, if there is a later disqualifying disposition before the ISO holding periods are met, the optionee must include in income the difference between the fair market value on the later of the exercise date or the vesting date, and the exercise price. Even if the Section 83(b) election is made on early exercise of an ISO, the IRS takes the position that the Section 83(b) election does not lock in the amount of ordinary income tax at the time of exercise when a later disqualifying disposition is made (all the Section 83(b) election does is lock in the amount of AMT on the date of exercise).

Accounting Treatment

ISOs generally receive the same accounting treatment as non-qualified stock options.

Advantages and Disadvantages

The primary advantage of ISOs over non-qualified stock options is the exemption from regular income tax on exercise. Also, the company is not required to withhold employment taxes on exercise of an ISO. This is a major advantage for a start-up company with limited infrastructure, since failure to withhold taxes can result in penalties for the company or for individuals within the company.

However, the AMT can be a significant disadvantage where the spread on exercise is substantial. The AMT rate is lower than the ordinary income tax rate on a non-qualified stock option, so the optionee can still pay less tax in the year of exercise of an ISO than it would pay in the year of exercise of a non-qualified stock option. This can be important for a start-up company employee who cannot sell shares to fund taxes.

Finally, for mature companies, the company can be at a disadvantage if an optionee holds an ISO for the full statutory holding periods because it will not then be entitled to a tax deduction for the value of the spread. However, the company can use the tax deduction on exercise in the case of disqualifying dispositions and most start-up companies have net operating losses that minimize the value of the tax deduction for options.

COMMON USAGE

Although a start-up company often grants restricted stock to founders and initial employees, as the value of the company's common stock rises, stock options are the most common form of equity compensation granted to employees. The obligation to collect or withhold income and employment taxes on exercise of a non-qualified stock option can be a substantial detriment to the company, particularly for start-ups with limited infrastructure because failure to withhold taxes can result in penalties for the company or for individuals within the company. Therefore, start-up companies often grant ISOs to their employees as the price of their common stock rises, but before they become profitable and can use the compensation deduction that would be available on the exercise of non-qualified stock options.

SECTION 409A AND VALUATION ISSUES

A start-up company must determine the fair market value of a share of stock on a specific date to grant stock options with an exercise price equal to or greater than the fair market value of the stock at the time of grant so that the stock options are exempt from Section 409A. The consequences are severe for granting a stock option with an exercise price that is less than the fair market value of a share of stock on the grant date. Under Section 409A, the holder of a stock option having an exercise price below fair market value at the time of grant must recognize taxable income each calendar year equal to the spread between the exercise price and the fair market value of the shares when they vest. Therefore, the optionee is taxed on income the optionee does not actually receive, from shares that may not then or ever be saleable.

Further, in addition to regular federal income and employment taxes, an additional 20% federal tax applies. Certain states (for example, California) have parallel statutes that impose an additional state tax. If a start-up company fails to withhold income and employment taxes (but not the additional Section 409A tax), it is then liable for those amounts and may be subject to additional penalties and interest. Therefore, a company should be certain that:

- It conducts valuations in a manner that complies with Section 409A.
- The grant of any stock option is made only based on a valuation method that is acceptable under Section 409A.

Section 409A provides that the fair market value of the stock of a company that is not readily tradeable on an established securities market may be determined by the consistent application of a reasonable valuation method. Whether a valuation method is reasonable or whether the application of the valuation method is reasonable is determined based on the facts and circumstances as of the given valuation date. Section 409A identifies the following three safe harbor methods for valuation:

- Independent appraisal.
- Formula valuation.
- Start-up company valuation.

For more information about these safe harbor valuation methods, see *Practice Note, Determining Fair Market Value of Equity Awards under Section 409A, Safe Harbor Valuation Methods for Privately Held Companies (http://us.practicallaw.com/1-502-0926#a1013357)*.

Most venture-backed companies routinely rely on professional independent appraisals to determine fair market value and set the corresponding exercise prices of compensatory stock options. The start-up company valuation method is rarely used due to:

- The burdensome requirement to memorialize the analysis in writing.
- The fear of exposing to liability the start-up company's internal finance experts.

If the company consistently uses a safe harbor valuation method, the company does not have the burden of proving that the fair market value determination is reasonable. Rather, the burden shifts to the IRS to prove that the fair market value determination is grossly unreasonable, reducing the likelihood of a successful challenge.

An independent valuation can be relied on for up to 12 months unless there are intervening events that may reasonably and materially impact the fair market value, such as a financing or receipt of a term sheet for an acquisition.

RESTRICTED STOCK UNITS (RSUS)

An RSU is the right to receive from the company, after the satisfaction of vesting requirements, either:

- A specified number of shares of common stock.
- Cash equal to the value of a specified number of shares of common stock.

If the employee fails to satisfy the vesting requirements, the RSU is simply forfeited. If the employee satisfies the vesting requirements, the company issues shares of common stock following the vesting date or, in certain cases, pays cash, which, in either case, is referred to as settlement.

A holder of an RSU is not the beneficial owner of the underlying shares. Unlike a restricted stock award, which is considered a transfer of property on grant, property is not transferred when an RSU is granted and the RSU is not taxed until the RSU vests and is settled. Settlement can be delayed beyond the vesting date, which allows for some tax planning, but this may make the RSU subject to Section 409A, which:

- Significantly limits the settlement date options.
- Can lead to severe tax penalties if the complex payment rules of Section 409A are violated.

For more information on Section 409A and potential penalties if a violation occurs, see *Equity Pitfalls under Section 409A Checklist: Issue One: RSUs Are Inadvertently Structured as Deferred Compensation Subject to Section 409A (http://us.practicallaw.com/3-502-9252#a955408)*.

RSUs retain value regardless of the performance of the start-up company's stock price (unless the stock price goes to zero). Therefore, RSUs are considered more valuable than stock options, the value of which is dependent on the company's stock price exceeding the stock option's exercise price. Accordingly, an award of RSUs typically covers fewer shares than a stock option grant.

FEDERAL TAX CONSEQUENCES

RSUs that are either exempt from or comply with Section 409A are generally taxed at ordinary income rates on settlement. Any payment of cash or stock on settlement is characterized as gross income from compensation for services under IRC Section 61. As gross income, the fair market value of the shares or the amount of cash received on settlement is subject to federal income tax at ordinary income rates. Because this gross income is considered wages, the company must withhold or collect the taxes due on settlement. When the employee sells the shares, the employee is then subject to capital gain or loss on the difference between the sale proceeds over the fair market value of the shares at the time of settlement.

Although federal income taxes are not recognized until settlement (assuming the RSU is either exempt from or complies with Section 409A), employment taxes, including FICA and FUTA taxes, are due on vesting of the RSU. The amount includible in income is based on the value on vesting for FICA and FUTA purposes and the value on settlement for income tax purposes.

RSUs are generally treated as nonqualified deferred compensation plans for purposes of FICA and FUTA. Under a special timing rule in IRC Section 3121(v)(2)(A) (for FICA) and IRC Section 3306(r)(2) (for FUTA), an amount deferred under a nonqualified deferred compensation plan (that is, the RSU) must be taken into account as income for purposes of FICA and FUTA as of the later of when:

- The services are performed.
- The right to the amount deferred is no longer subject to a substantial risk of forfeiture (that is, vesting).

For purposes of FICA and FUTA, services creating the right to an amount deferred are considered performed when, considering the relevant facts and circumstances and the terms of the plan or agreement, the employee has performed all of the services necessary to obtain a legally binding right to the amount deferred, disregarding any substantial risk of forfeiture. For RSUs, this occurs at vesting. Under a nonduplication rule in IRC Section 3121(v)(2)(B), because the RSUs are taken into account as wages under the special timing rule, the value of the RSUs are not subject to FICA or FUTA taxes again when the RSUs are actually settled and become subject to federal income taxation, assuming those taxes are paid on vesting.

Property is not considered transferred at the time an RSU is granted and, therefore, an employee may not choose to make a Section 83(b) election to be taxed on receipt of the RSU. In the case of stock-settled RSUs, long-term capital gain treatment is possible on the later increase in the value of shares after settlement, but most holders sell all shares on settlement if the shares are saleable.

The company is generally entitled to a tax deduction in the amount, and at the time, the employee recognizes ordinary income.

ACCOUNTING TREATMENT

Assuming the typical vesting provisions used by a start-up company described earlier, the fair value of a stock-settled RSU granted to an employee generally must be reflected as a compensation expense for financial accounting purposes on grant and expensed over the expected vesting period. For more information about the accounting treatment of equity compensation awards, see *Practice Note, Drafting an Equity Incentive Plan for a Private Company: Accounting Considerations (http://us.practicallaw.com/9-504-0685#a911994)*.

ADVANTAGES AND DISADVANTAGES

Key advantages of granting a stock-settled RSU include:

- The company is not required to make any cash payments.
- No appraisal is required to grant RSUs, unlike stock options.

A key disadvantage of granting an RSU is that the employee does not control the timing of the tax event, unlike with a stock option or, to some extent, a restricted stock award (to the extent a Section 83(b) election is made). Also, the RSU vesting and settlement must be structured to be exempt from or compliant with Section 409A.

COMMON USAGE

RSUs are not often granted by a start-up company in its early stages. Due to tax complexities, issuing RSUs requires that the company or the employee have sufficient cash to fund the taxes that are due on settlement or postpone vesting until sufficient cash is available to fund the taxes. As a result, RSUs are rarely granted by start-ups, except in one-off situations, until the start-up has sufficient cash and a reliable income stream. RSUs are usually granted by mature, highly valuable companies typically when the fair market value of the common stock is too high for stock options to be motivating to employees. RSUs do not offer employees the opportunity to obtain long-term capital gains treatment, but when the value of the common stock is high, the opportunity to eventually acquire stock for no purchase price can be attractive for employees.

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