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The Latest and Greatest in Equity Compensation

- Tommy McCollister, CPA, Senior Manager, Armanino
- Page Griffin, Partner, Skadden, Arps, Slate, Meagher & Flom
- Michael Klippert, Partner, Wilson Sonsini Goodrich & Rosati

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The Latest and Greatest in Equity Compensation

Road Map

- ***Option Repricings & Exchanges***
  - Benefits and Drawbacks
  - Frequency
  - "Gossamer Style" Repricings
- ***Equity Award Matters***
  - RSUs versus Options
  - Private Company RSUs with Double Trigger Vesting
  - Special Equity Awards
  - Employee Elections between Options and Cash
- ***Disclosure and New Dodd Frank Rules***
  - Clawback Rules and Effect on Performance-Based Awards
  - General Tups on Equity Disclosure
  - Reg S-K Item 402(x)
  - "Spring Loaded" Awards and Accounting Treatment

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Benefits and Drawbacks of Option Exchanges and Repricing

Benefits:

Non-cash solution to re-incentivize existing option holders

Helps prevent negative sentiment between new hires and existing/longer-term option holders

Can be done in a manner that has a low net cost to the company

Can be structured to minimize financial statement impact

Drawbacks:

Administrative costs

Tax and accounting complexities

Potential ISO disqualification

Optics

Getting stakeholder alignment

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Types of Option Exchange and Repricing Programs

Option for option

Cancel underwater options and issue new options with strike prices at, or greater then, the current (lower) FMV.

- No change in number of shares
- Reduced number of shares (value for value)
- Additional vesting conditions

Option for other security

Exchange underwater options for other equity-based awards (e.g., RSUs).

- Eliminates possibility of needing successive repricings

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Tax Considerations

Multiple repricing events and potential 409A exposure:

Preamble to proposed regs: ... depending upon the facts and circumstances, a series of repricings of the exercise price may indicate that the original right had a floating or adjustable exercise price and did not meet the requirements of the exclusion at the time of the original grant.

Potential severe penalties, etc.

Potential loss of ISO status

Treated as the grant of a new award

ISO 100,000 limit is retested in year of repricing

- Don't forget about the "duplication rule" in §1.422-4(b)(5)(ii)

Must meet all other ISO qualification requirements

Beware the 30 day rule for offers to change the terms of an ISO

Potential loss of performance exception if old 162(m) comes back

1.162-27 regulations require the plan to state the maximum number of shares to be granted to any individual employee during a specified period. In a repricing, both the cancelled grant and the new repriced grant count toward the maximum limit.

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Accounting Considerations For Repriced Awards

ASC 718 – account for a modification unless:

Fair value of the modified award is the same as the modified award immediately before the modification

Same vesting conditions

Same classification (equity or liability)

Modification accounting:

A modification where only the strike price is reduced is referred to as a "Type I modification" (probable to probable)

- An incremental expense is booked for the increase in fair value of the new award
- Company will need to track the incremental expense, as well as any windfall/shortfall
- Expected Term – cannot rely on past history. Simplified Method and Practical Expedient may not be available.

Equity Administration Systems

Need to track both old award and new modified replacement award for expense attribution and settlement

Systems may not provide appropriate functionality

Manual workarounds (we all love)

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Options vs. RSUs

	Options	RSUs
What is it?	Right to purchase shares in the future at a price specified on the date of the grant (usually FMV on grant date)	Right to receive a share of stock when vested
Value	FMV on date of exercise less purchase price	FMV of shares on date of settlement
Payment for Shares	Payment of exercise/purchase price	No cash payment to receive shares
Tax	Tax upon **Exercise and at Sale**	Tax at **Vest and at Sale** - Shares are delivered upon vesting; and there is ordinary income equal to the FMV of the shares on the date of issuance
Mostly Seen In…	All stages of companies (i.e., early stage, high-growth startups, mature public companies)	Public companies; some private companies with substantial valuations (generally at least greater than one billion or more)

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When do companies switch to RSUs?

1. Discount between the most recent preferred and the common is shrinking.
2. Board and investors are signaling the burn rate / dilution from existing options and continued granting is too high.
3. Talent acquisition team signals that they are unable to close candidates with options

Typically, all three of these factors are in place before a switch to RSUs occurs.

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Two-Pronged RSU Vesting--Two Different Vesting Conditions:

Continued Service – "Time-Based Vesting"

- Continued employment determines the number of shares that will be issued on settlement
- Time-based vesting schedule to be determined – generally 4 years

Occurrence of an IPO/lock-up expiration or Change in Control – "Liquidity Event Requirement"

- Can structure to require continued employment through the liquidity event (i.e. "stay in seat" requirement)
- If "butt in seat" is not required, must determine whether the liquidity event constitutes a "substantial risk of forfeiture" standing on its own (i.e., "Facebook style")

Decision Point

"Stay in Seat"

or

"Facebook Style"

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RSU Vesting Considerations

For an RSU to remain unvested for tax purposes, there must be a "substantial risk of forfeiture."

"***Stay In Seat***"

An RSU that requires continued employment through vesting will be exempt from Section 409A

- Continued employment is considered a "substantial risk of forfeiture"

"***Facebook Style***"

If continued employment through vesting is **not** required, the RSU must still be subject to a "substantial risk of forfeiture" to be exempt from Section 409A

- The achievement of a performance condition may be considered a "substantial risk of forfeiture" standing on its own – performance conditions could include a liquidity event (including an IPO)

Test for a "substantial risk of forfeiture" under Section 409A is:

- The event must be "related to a purpose" of the award; and
- The risk of the event not occurring must be substantial as measured at the time of grant

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Liquidity Event As "Substantial Risk of Forfeiture" ("Facebook Style")

No specific guidance from IRS on applying the substantial risk of forfeiture test, therefore a facts and circumstance analysis

Many practitioners have taken the position that any liquidity event can represent a "substantial risk of forfeiture"

Informal guidance from the IRS is that they are skeptical of this position and will view this with greater scrutiny

The outside date by which the liquidity event must occur will impact the analysis – the shorter the period, the more likely that the liquidity event will not occur and thus improves the argument that there is a "substantial risk of forfeiture"

At time of grant, must consider the likelihood of an IPO or M&A event occurring during the chosen period

Some practitioners take the position that any outside date creates a substantial risk of forfeiture (like 7 years from the date of grant), ***but the analysis is more involved than that***

For instance, if 7 years from grant was chosen as the outside date and management and the Board believed there was a 90% chance an IPO or M&A event would occur in that time period, then it likely would <u>not</u> be viewed as a "substantial risk of forfeiture"

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Special Equity Awards

- ***RSUs with Performance-Based Vesting Conditions***
  - Managing Tax Withholding
  - Form 4 Requirements
- ***SARs***
  - When do Companies Grant SARs
  - "Capped SARs"
- ***Options with Exercise Periods in Excess of 10 Years***
  - Purpose
  - Accounting/Tax Considerations

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Employee Elections between Options and Cash

Constructive Receipt Tax Doctrine

- ***IRS Guidance*** - The IRS has issued a number of Revenue procedures which specifically deal with guidelines to avoid constructive receipt - Rev. Proc. 71-19 and Rev. Proc. 92-65:
  - The election to defer must be made before the beginning of the period of service for which the compensation is payable, except in the case of a new plan or newly eligible to participate.
  - When a new plan is implemented, a participant may elect to defer future compensation within 30 days after the effective date of the plan.
  - A newly eligible participant may elect to defer future compensation within 30 days of becoming eligible.
  - If an election, other than the initial election of a deferral amount, is made subsequent to the beginning of the period of service, the plan must set forth substantial forfeiture provisions that remain in effect throughout the entire period of deferral.
- ***Case Law*** - The courts have generally been more liberal than the IRS in interpreting the doctrine of constructive receipt. Courts have not always required that, for a valid deferral to occur, the election to defer compensation be made prior to the rendering of services by the employee.
  - *Veit v. Commissioner*, 8. T.C. 809 (1947): In Veit, the court held that an employee could defer taxation on a bonus for a year, even though the election to defer was made after the services to which the bonus pertained had been rendered.
  - *Oates v. Commissioner*, 18 T.C. 570 (1952): In Oates, the court held that the employee had a valid deferral of income where the agreement to defer had been entered into after the services had been performed but before the amount of the commissions earned by the services was determined.
  - *Martin v. Commissioner*, 96 T.C. 814 (1991): In Martin, a post-service election to defer was permitted where the taxpayer had the right to elect between a lump sum and installments with respect to the payment of "shadow stock" units before the amount of the later payments was fully ascertainable.

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Employee Elections between Options and Cash

Constructive Receipt Takeaways:

- The safest approach is to comply with IRS guidance by requiring employees to elect between cash and options before the start of the services necessary to generate the compensation.
  - Usually, this means the election should be made in the calendar year prior to the year when the compensation is earned.
- Another approach is to permit the election after the services necessary to earn the cash or options have commenced, but to require the employees to remain employed for several months following the election in order to receive the cash bonuses or option grants.
  - Although the specific amount of time necessary to remove constructive receipt issues is unclear (and the IRS may still challenge the arrangement), a company could decrease the likelihood of courts finding that the constructive receipt doctrine applies if the employees' rights to receive the compensation at the time of the deferral elections are subject to greater limitations.

Dodd-Frank Clawback Policies

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DF Clawback Policies – Background

On October 26, 2022, the SEC adopted final rules under Dodd-Frank, requiring stock exchanges to establish listing standards that require listed companies to adopt policies providing for the recovery of erroneously awarded compensation received by current and former executive officers, regardless of misconduct.

Each listed company is required to:

- Have adopted a clawback policy that was effective no later than December 1, 2023
- Comply with the DF clawback policy
- Provide the required disclosures in connection with the DF clawback policy in the Form 10-K and proxy statement.

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DF Clawback Policies – Background (cont.)

The DF clawback rules apply to "erroneously awarded" "incentive-based compensation" "received" during the three completed fiscal years preceding "the date the company is required to prepare" "an accounting restatement" due to material noncompliance with financial reporting requirements

- "**Erroneously awarded**" means the excess of the compensation actually received over the amount that would have been received if determined based on the restated (i.e., correct) financial reporting measure, computed on a pre-tax basis;
- "**Incentive-based compensation**" means any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure, including stock price and TSR;
- Compensation is deemed to be "**received**" in the fiscal year during which the financial reporting measure is attained, even if the payment or grant occurs later;
- "**The date the company is required to prepare**" an accounting restatement is the earlier to occur of (i) the date the board concludes (or reasonably should have concluded) that a restatement is required or (ii) the date a court or regulator directs the company to prepare a restatement, even if the restatement itself was filed later; and
- "**Accounting restatements**" include both "Big R" and "little r" accounting restatements, but not "out-of-period adjustments"

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DF Clawback Policies – Policy Triggered?

If, during or after the last completed fiscal year the company was required to prepare a restatement that required recovery of erroneously awarded incentive-based compensation under the company's clawback policy, or there was an outstanding balance as of fiscal year end of erroneously awarded incentive-based compensation to be recovered from a previous application of the policy, the listed company is required to disclose:

- (a) the date it was required to prepare the restatement;
- (b) the aggregate dollar amount of erroneously awarded incentive-based compensation, including an analysis of how the amount was calculated (with enhanced disclosure if the financial reporting measure related to stock price or TSR); and
- (c) the aggregate dollar amount of erroneously awarded incentive-based compensation that remains outstanding at the end of the last completed fiscal year (alternative disclosure would be required if the aggregate dollar amount of erroneously awarded incentive-based compensation had not yet been determined).

If recovery would be impracticable in accordance with the narrow exceptions in the Dodd-Frank clawback rules, companies are required to briefly disclose why recovery was not pursued and the amount of recovery foregone for each current and former named executive officer and for all other current and former executive officers as a group.

DF Clawback Policies – Policy Triggered? (cont.)

For each current and former named executive officer from whom, as of the end of the last completed fiscal year, erroneously awarded incentive-based compensation had been outstanding for 180 days or longer since the date the listed company determined the amount owed, the dollar amount of outstanding erroneously awarded incentive-based compensation due from each such individual should be disclosed.

If the company was required to prepare a restatement during or after its last completed fiscal year and concluded that recovery of erroneously awarded incentive-based compensation was not required under the clawback policy, the company is required to briefly disclose the reasoning behind such conclusion.

Companies must also incorporate any recoupment of compensation into the amounts shown for the year of recoupment in the Summary Compensation Table by subtracting the amount recovered from the amounts reported in the Summary Compensation Table for that year and quantifying the amount recovered in a footnote.

Equity Disclosures and Item 402(x)

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Option Grant Practice Disclosures

Under Regulation S-K Item 402(x), which was adopted on December 14, 2022, companies (including smaller reporting companies and EGCs) will be required to disclose on Form 10-K or in the annual meeting proxy statement the company's policies and practices regarding the timing of awards of options in relation to the disclosure of material nonpublic information.

The Item 402(x) disclosure requirements will be effective for the proxy filing that covers the first full fiscal year beginning on or after **April 1, 2023** (or **October 1, 2023, for smaller reporting companies**).

Companies will need to discuss:

- How the timing of awards is decided;
- How material nonpublic information is considered, if at all, when determining the timing and terms of awards; and
- Whether disclosure of material nonpublic information is timed to affect the value of such awards.

Renewed focus:

- 402(x) is in addition to existing CD&A disclosure requirement that companies discuss how the determination is made as to when options and full-value awards are granted.

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Option Grant Practice Disclosures (cont.)

Companies will also be required to disclose in a new table any options granted in the last completed fiscal year to NEOs that were granted within four business days before or one business day after the (i) filing of a periodic report on Form 10-Q or 10-K or (ii) filing or furnishing of a current report on Form 8-K that contains material nonpublic information (other than disclosure of a material new option award grant under Form 8-K Item 5.02(e)).

The table will be required to disclose:

- Each award (including the grantee's name, the number of securities underlying the award, the date of the grant, the grant-date fair value and the option's exercise price); and
- The percentage change in closing market price of the securities underlying each award on the trading day before and after disclosure of the material nonpublic information.

Staff Accounting Bulletin No. 120

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SAB 120

SAB 120 is the accounting partner to the renewed focus on "spring-loaded" equity awards under Item 402(x).

- A company that grants an equity award while in possession of positive material nonpublic information should consider whether adjustments to the following are appropriate when determining the fair-value-based measure of the award for purposes of ASC 718: (i) the current price of the underlying share or (ii) the expected volatility of the price of the underlying share for the expected term of the share-based payment award.

Significantly, SAB 120 applies to all equity awards (including restricted shares and RSUs), not just options.

- For grants of full-value awards that are sized based on a market value for the underlying shares — where the grant is in advance of the public announcement of material nonpublic information — the company should at a minimum have a record of considering whether those awards were sized appropriately given the potential impact of the announcement on the award value.

How will companies respond to SAB 120 and 402(x)?

- Fixed grant timing policies?
- Grants effective only during open trading windows?