Let's face it- in the startup game, it's all about the equity. Equity compensation plans, which include stock options, permit young companies to compensate employees, consultants and other service providers in a cost effective manner. There are several types of equity incentives, each with it's own unique tax and accounting implications. The common forms of equity incentives among technology companies are stock options, restricted stock, and phantom stock/stock appreciation rights.

Equity Compensation Plans

Equity compensation or incentive grants are subject to the conditions contained in a written plan ("option plan") or in the grant itself. The option plan often gives the company's Board of Directors the authority to issue grants and establish the conditions of each grant, including, price, amount, and vesting. Vesting is a period of time the recipient holding the option grant must wait until they are capable of fully exercising their rights, and until those rights may not be taken away should the recipient terminate service with the company.

Options

A stock option is a right granted by a corporation to a recipient to purchase stock based upon certain conditions and at a set price. Many companies institute stock option plans for their employees to create an ownership mentality and enhance compensation without spending capital. There are two types of stock options used for employee compensation: Non-Qualified Options ("NQOs") and Incentive Stock Options ("ISOs").

A stock option offers the recipient (or "optionee") the right to acquire shares of the company's stock (these are the shares "underlying" the option or "option shares") based on certain conditions but the option does not provide the optionee any benefits of stock ownership – such as voting rights or the right to receive dividends.

Nonqualified stock options

Nonqualified stock options (also known as "Nonstatutory Options") can be granted to employees, directors, consultants and other service providers. When the option is exercised (meaning the optionee pays the company the option price and is entered on the books of the company as the shareholder of record) the difference between the option price and the fair market value of the shares is taxed as ordinary income, and the company receives a corresponding compensation deduction. For the recipient, any additional gain on the sale of the stock is taxed at the applicable capital gains rate.

Incentive stock options

Incentive stock options can be issued only to employees. With NQOs, the optionee does not recognize any income at exercise of the option, but at the time of the sale of

the underlying shares. At that time, the entire taxable amount (the difference between the option price and the strike price) is treated as long term capital gain instead of ordinary income. But this is only if the shares are held for two years after the option grant and one year after the option is exercised. In the event that the holding period requirements or other conditions are not met, then the option converts to a NQO and is taxed as ordinary income.

Restricted Stock

Unlike stock options, which merely convey the contractual right to the recipient to acquire shares of a company, restricted stock is stock in the company that comes with all of the benefits of stock ownership, but is subject to restrictions imposed by the company at the time of grant. These conditions may include the company's right to repurchase the restricted stock if the recipient's service with the company is terminated before the restricted stock fully vests. Restricted stock is often issued in exchange for cash and/or services at a price equal to or less than the stock's fair market value. As restricted stock vests, the difference between the original purchase price and their fair market value at the time of vesting is taxed as ordinary income. When the restricted stock is sold, then the difference between the sale price and the price at the time of vesting is taxed at the applicable capital gains rate. However, the recipient may make an election at the time of the grant of the restricted stock and pay the tax of the value of the entire grant at the time the election is made, and then claim capital gains treatment on any future gain.

Alternatives to Stock Options

An alternative to the stock option grant are stock appreciation rights ("SARs") and phantom stock. SARs are contractual rights to receive, usually in cash, the appreciation in the value of stock over a period of time. Another alternative is phantom stock. With phantom stock, an employee receives a contractual "units" that allow the employee to receive payments based on increases in the company's value. The employer simply credits on the books of the company the employee with hypothetical shares of stock. At a specified payout date or event, the employee would receive the value of his account or just the increase in value of his account from the date of creation.

There are two advantages to SARs and Phantom Stock. The company will not have any additional shareholders. Second, the tax aspects may be simpler since the employee will have taxable income when he receives the payment, and the employer has a deduction at the same time.