WILSON SONSINI

The UK Startup's Guide to Making Equity Plans Work for US Employees

Daniel Glazer
London Office Managing Partner at Wilson Sonsini

When UK emerging companies venture outside the UK, they quickly need to address whether – and how – to extend equity-based compensation to non-UK employees. Unfortunately, few jurisdictions offer a regime as favorable as the UK's Enterprise Management Incentives (EMI) scheme for providing equity compensation to emerging company employees.

The discussion below provides guidelines for making this work. Although the focus is on extending equity-based compensation to US employees, the issues addressed have broader applicability.

1. Provide for non-EMI grants of options and shares. When adopting an EMI scheme, include provisions (potentially in a separate Part 2) that permit the issuance of options that do not qualify under EMI to non-UK employees. Ideally, the plan also should permit equity awards other than options, including share awards. For example, if the valuation of your shares is low, a US employee may prefer to obtain better tax treatment by receiving a share grant and electing to be taxed as ordinary income at the time of grant, with future increases in value taxed at capital gains rates. Assuming "reverse vesting" (see below), this will require that the employee file a US Internal Revenue Code Section 83(b) election within 30 days of the grant (this is similar to the employer/employee joint Section 431 election made on an acquisition of restricted shares under UK tax law). In some cases, share awards may even make sense in the UK.

2. Provide for "reverse vesting". If you wish to issue share awards, you are likely to want to have a mechanism to recover awards that have not been fully earned if the individual leaves prematurely. This is referred to as "reverse vesting." Implementation of reverse vesting requires inclusion of special provisions in your articles of association. It may make sense to include this mechanism in your articles in any case, because you may need to recover shares from a departing founder who has received shares. The British Venture Capital Association has developed standard forms of these provisions, although they may require moderate tailoring for your situation. These provisions avoid UK company law issues associated with a company's reacquisition of its own shares by instead converting the forfeited shares into "deferred shares" with no value.

3. Obtain appropriate fair market valuations. You typically are going to need to secure a valuation of your company's shares at the time of the options or shares grant to comply with relevant tax requirements, whether under UK tax law (for example, for purposes of confirming that EMI options are being issued at market value and consequently won't trigger tax at the time of exercise, or that the values of the options or shares do not exceed relevant thresholds) or under other tax law.

For example, it is very important under US tax law that the exercise price of employee options is fixed at fair market value (or higher) in order to avoid penal provisions under Section 409A of the US Internal Revenue Code. While these penalties apply to the employee and not to his or her employer, having a very unhappy employee is not the purpose of an employee equity incentive!

A valuation of your shares that meets UK HMRC standards may not suffice for US tax purposes. In general, the application of UK HMRC valuation standards results in a lower value than a US compliant valuation of the same shares. Consequently, if you wish to make grants to US employees, you will need to determine whether to use separate valuations for UK and US purposes or rely on the higher valuations determined under US principles for both UK and US purposes. Correct valuation processes are very important for the purposes of granting options to US employees. This is a highly scrutinized issue, and improperly priced options will negatively impact your company's financings, M&A and other exit activities. **You should speak with your attorney prior to making option grants to US employees**.

4. Set options exercise prices appropriately. It is common in a UK context for emerging companies to issue options with a nominal exercise price or, at most, a UK-qualifying fair market value exercise price. For the reason indicated in (3) above, this will not work for US purposes and options issued to US employees will need to have a US-qualifying fair market value exercise price. Consequently, you need to address up-front whether you are going to have different exercise prices in simultaneous grants of options to your UK and US employees and, if so, whether this should have any impact on grant levels.

5. UK and US valuation standards vary but there are common approaches. In both the UK and the US a lower value can be justified for common stock (ordinary shares) issued or granted under option to employees than the price paid for by outside investors as the outside investors will generally receive convertible preferred stock (convertible preference shares) with a liquidation preference. This liquidation preference provides, at a minimum, a right to get paid first in certain circumstances before the common stock receives any value. Discounts can also be applied to reflect the minority and illiquid nature of employees' holdings.

6. Take into account the local taxation of share and option grants. You will need advice in each jurisdiction in which you make equity grants as to what mechanisms work best.

In the US, as suggested above, a share grant that is taxed as ordinary income at fair market value at the time of grant (with no discount for risk of forfeiture due to reverse vesting) may make sense for some senior executives if the current valuation of your shares is low enough; otherwise, you will need to grant options.

If granted correctly, there will be no recognition of income for US tax purposes at the time an option is granted. A tax event generally occurs at the time options are exercised, except under a class of tax-favored options known as Incentive Stock Options (ISOs) that may allow an optionee to delay income recognition until the optionee sells or transfers exercised shares, at which time the tax event may be treated more favorably. In addition, the Company does not have a tax withholding obligation with respect to ISOs. To qualify as an ISO, an option must be granted to an employee and meet certain requirements, including that any shares purchased be held for at least one year after exercise and two years after the date the option was granted. [For more on the differences between ISOs and non-ISOs, see this article from our partner Yokum Taku].

We recommend that emerging companies consider granting ISOs to employees. As an illustration, if a company grants an option to an employee on January 1 of year 1, the employee exercises that option on January 1 of year 2, and the employee sells the shares on January 1 of year 3, the difference between the exercise price and the fair market value at year 3 is treated as a long-term capital gain (which is currently taxed at a maximum rate of 20%). That same option granted as a non-ISO would have two taxation events: first at year 2, when the difference between the exercise price and the fair market value at year 2 is treated as ordinary income (which is currently taxed at a maximum rate of 37%), and again at year 3, when the difference between the fair market at year 2 and the fair market value at year 3 is treated as a long-term capital gain. However, ISOs may be subject to unfavorable tax treatment under the US "alternative minimum tax." An advantage of a non-ISO is that the value of the shares issued (over the option exercise price) is deductible by the company as a compensation expense, while ISOs are not. However, this is not frequently a primary concern for early-stage companies.

* * *

Managing cross-border employee compensation is complex, particularly so with respect to equity compensation. However, with a little effort, you can adapt your equity compensation plan to give you the flexibility to deal with these cross-border issues when and if they arise.

Article produced in partnership with Daniel Glazer, Sriram Krishnamurthy, Fleur Benns, and Matthew Norgard at Wilson Sonsini Goodrich & Rosati. The foregoing does not constitute legal advice and should not be relied upon for business or legal decisions.

[Special thanks to Robert Mollen for his contributions to a prior version of this article].