Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 13
What Non-US Startups Need to Know About Granting Stock Options

By Darren Goodman, Dotan Barnea, Taryn E. Cannataro
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Taryn Cannataro: Welcome to the latest edition of "Just Compensation". I'm Taryn Cannataro and I'm an associate in our Employee Benefits and Executive Compensation Group. I'm joined today by two colleagues who I will turn it over to introduce themselves.

Darren Goodman: I'm Darren Goodman. I'm a partner in the firm's Executive Compensation Group.

Dotan Barnea: And I'm Dotan Barnea. I'm a partner in the firm's Tech Group, and I also co-chair the firm's Israel practice.

Taryn Cannataro: Today, we're going to be discussing some items that non-U.S. startups that want to grant stock options or other equity awards in the U.S., should know. The issues that we'll discuss today are very technical, in fact, and circumstance specific. This discussion is not intended to be legal advice for any individual situation. We recommend consulting with counsel before granting any equity awards. Let's get started. What's the typical scenario where you would see a non-U.S. startup granting equity awards in the United States?

Darren Goodman: We normally see this when the startup is establishing a U.S. subsidiary and it's hiring its first U.S. employees. The startup often has an equity plan in place, but it's geared toward the country in which it's formed, and it hasn't been reviewed by U.S. counsel. And when they're hiring the U.S. employees, often employees being hired by a startup are looking for stock option grants.

Dotan Barnea: That's right. And it actually ties to the broader challenge that our foreign startup clients face. By operating in two or more jurisdictions, these startups need to understand and comply with multiple sets of rules. For example, we have a good amount of clients that are Israeli corporations. They typically have an equity plan that allows them to grant options to Israeli employees and service providers, in a way that complies with the relevant Israeli tax rules. In order to properly grant equity awards to employees and service providers, based in the U.S., the plan, the grant documents, the operating procedures, requires some adjustments.

Taryn Cannataro: What should a non-U.S. startup be aware of before they grant equity awards?

Darren Goodman: The first thing that they need to be aware of is United States tax considerations. In the U.S., there are two different types of stock options: incentive stock options and non-qualified stock options, as we talked about on one of our prior podcasts.

Dotan Barnea: Right. And the U.S., as Darren mentioned, like other tech focused jurisdictions, offers a beneficial tech treatment for options, provided that such options comply with certain requirements. In that sense, incentive stock options are analogous to section 102 options in Israel or EMI options in the UK. However, the benefits and the requirements change from jurisdiction to jurisdiction. Compared to the default non-qualified stock options, incentive stock options allow the recipient to defer the taxable event, meaning that instead of paying taxes upon exercise of options, the tax event will only occur upon the sale of shares that they receive from exercising the incentive stock option.

Dotan Barnea: And in addition, incentive stock options provide the potential for long term capital gains, for all increase in value above the exercise price. So if an incentive stock option holder exercises their options and holds the shares for at least two years from the date of exercise, and one year from the date of grant, they can benefit from long term capital gains. And just to sum it up, it's worth noting that for option holders who hold onto their options and don't exercise until the exit, there's no real difference between holding incentive stock options or non-qualified stock option. The benefit provided by incentive stock options, it's quite limited if you compare it to the benefit that's given in other jurisdictions.

Taryn Cannataro: Well, to grant incentive stock options, though, there are a number of requirements under the U.S. Internal Revenue Code that must be satisfied. How does that work for a non-U.S. company?

Dotan Barnea: A non-U.S. plan usually is not designed to satisfy the U.S. requirements. For non-U.S. companies or startups, they need to put in place a sub plan or a supplement with terms that are needed in order to comply with the incentive stock option rules.

Darren Goodman: And one thing that non-U.S. startups need to be aware of is that, one of the U.S. incentive stock option requirements is that the sub plan has to be approved by the stockholders within 12 months of the time that it's adopted. And then, if there's ever an increase in the number of shares available for ISO grants, that requires a re-approval by the shareholders within the 12-month window.

Taryn Cannataro: Could you tell us more about how the U.S. sub plans work? What do they look like? Who does it apply to?

Dotan Barnea: Sure. The sub plan is layered on top of the regular equity plan that applies to all the employees. People in the U.S. would get awards that are subject to both the regular or master plan and the sub plan. And if there's ever a conflict, the sub plan would control.

Taryn Cannataro: Besides provisions for incentive stock options, is there anything else that would be included in the U.S. sub plan?

Darren Goodman: In the U.S., stock options are regulated by section 409A of the Internal Revenue Code. 409A is very complicated, but one impact is that for purposes of compliance with 409A, the exercise price of stock options is almost always set at fair market value on the date of grant. We would normally build that requirement right into the sub plan. Otherwise, we'd review the company's master plan and see if there are any issues raised, whether under 409A or another provision of U.S. law. It can really vary from plan to plan. Sometimes there are a number of provisions that need to change, other times, the non-U.S. plan is generally fine.

Dotan Barnea: It isn't part of the sub plan, but another thing to be aware of is that grants in the U.S. need to have a securities exemption under the Securities Act. The typical exemption for startups granting equity awards to employees and service providers, is the exemption provided by rule 701. It has a number of tricky requirements, so U.S. counsel should be consulted. And one big limit is that grants to consultants are only covered by rule 701, if the consultant is a natural person, with the exception where the grant is being made to a company that the consultant owns, and the company is essentially an alter ego of the consultant.

Darren Goodman: It's a great point, Dotan, and another securities point for companies to be aware of is that states can have their own securities laws, called Blue Sky Laws. Complying with the Blue Sky requirements would require looking at each state where equity awards are being granted.

Taryn Cannataro: Once there's a sub plan put in place and the company confirms that they have a securities exemption for awards, what other legal work is involved?

Darren Goodman: Putting the sub plan in place is usually the most time intensive aspect, but usually there's a need for some ongoing compliance work. The good rule of thumb is to consult counsel whenever a change to options is being contemplated. Often time changes are fine, but sometimes they could run afoul of U.S. tax regulations or could require option holder consent. We also recommend involving us whenever new options are being granted, just to make sure that all the boxes are being checked off. For example, that the options are being granted at fair market value and making sure that nothing's happened that could impact the determination of fair market value.

Taryn Cannataro: Dotan, why don't we circle back to something that you mentioned earlier? You said that the sub plan would apply to people in the U.S.. What about somebody who is outside the U.S., but then moves to the U.S.?

Dotan Barnea: That's a great question. There are two different types of people to consider here. The first is people who are outside the U.S., but are U.S. taxpayers; that could be U.S. citizens working overseas, for example. The U.S. taxes its citizens on their worldwide income, so U.S. tax compliance needs to be taken into account for such people, even if they're living and working outside the U.S.. This is something many people don't realize and normally see their options subject to the sub plan too. The second group of people to consider is people who are outside the U.S., are not U.S. taxpayers, but they move to the U.S. and become U.S. taxpayers. For that group, it's a case by case analysis, and it's important to discuss with counsel before any such person moves to the U.S..

Taryn Cannataro: What if a company wants to avoid this complexity altogether? Are there any cash bonus plans that it could implement instead?

Darren Goodman: They could, these are normally called Phantom Equity plans because the goal is to mimic the value an employee would've received if they'd been granted options or stock. It avoids some of the nuances we've been talking about, but it introduces new ones that could fill an entire podcast on its own.

Taryn Cannataro: Well, unfortunately we're out of time, so we'll need to tackle that topic on another day. But are there any last thoughts from either one of you?

Dotan Barnea: Sure. We focused on the nuances because it's important for non-U.S. startups to be aware of them, but don't be deterred by that, because non-U.S. startups grant equity awards in the U.S. all the time. And U.S. employees will expect that, so it's important to be mindful of the fact that U.S. counsel should be involved at the outset. Planning ahead in this case and many others, can save a lot of headaches later on.

Taryn Cannataro: Thank you both and thank everybody else for joining us today. This session was intended to give you some high level food for thought on a few issues that we see arise, for non-U.S. startups that have or intend to issue stock options or other equity awards in the U.S.. But this is by no means, a comprehensive discussion of all considerations, and these may not apply to your particular situation. We encourage you to consult with counsel to help with the issues we discussed. We look forward to having you back for our next episode of Just Compensation. Thanks for joining today.

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