THE INS AND OUTS OF EQUITY COMPENSATION PLANS: PRE-IPO COMPANIES

WHAT IS IT?

Pre-initial public offering (IPO) companies focus their incentive compensation on equity grants to a wide array of employees. Whether the ultimate liquidity event is achieved by going public through an IPO, merging with a special purpose acquisition company (SPAC), a direct listing, or through a purchase by a private or public enterprise, the event can bring considerable wealth to early investors and employees.

Pre-IPO equity compensation plan designs are distinct from those of publicly held companies. They include important tax factors that employees and their advisors should understand and incorporate into a strategic approach. *This piece focuses on pre-IPO companies.*

Private company stock is far less liquid than public company stock. The liquidity event (IPO or sale of the company) is a critical factor in both increasing the stock's value and its liquidity if it trades on a public exchange after the event. Although the grant forms are generally similar to a public company, the plan rules, potential lockup periods and lack of liquidity call for a different strategy and focus. There are two types of equity grants and two different forms under each type.

Exercisable:

- The grant can take the form of nonstatutory options (sometimes called nonqualified stock options) and/or incentive stock options (ISOs).
- ISOs are common in pre-IPO companies but increasingly rare in publicly held companies.
- To acquire stock, the employee must exercise the option at the preset exercise price, which is generally close to the fair market value (FMV) of the stock when it's granted.
- Grants typically have a four-year vesting schedule (usually a cliff vesting followed by graded vesting); unexercised options expire generally after 10 years.
- Some companies apply a shorter five-year expiration period for ISO grants.

Restricted:

- The grant form is restricted stock awards (RSAs) or restricted stock units (RSUs).
- The stock is acquired when the restriction lifts; often time-based (RSA and RSU) or time- and event-based (RSU).
- The event is a liquidity event — either an IPO, merger with a SPAC, or a purchase and sale.
- Grant recipients who are employed when the restriction(s) lifts acquire the stock.

- Double restriction RSU grants, which time vest before an IPO, often have a substantial post-IPO delay in the delivery of the stock (up to 180 days or more).
- Four years is a common time-vesting schedule in pre-IPO companies; they often start with cliff vesting followed by graded vesting. Pre-IPO RSUs can also have an expiration period.

WHO PARTICIPATES?

- Early employees are broadly offered equity compensation, as well as executive-level employees who join at later stages in the company's growth.
- Early employees have opportunities to acquire company stock at a low cost and low tax friction.
- Some companies offer both exercisable and restricted grant types to their employees.
- Understanding the types and forms of the awards, and the governing plan rules, is critical to crafting an optimal strategy.

HOW DOES IT WORK?

Employees who are awarded grants should view them in two ways:

1. As potential W-2 compensation if the stock is acquired, subject to the same tax treatment as cash compensation.
2. Once acquired, as a personal investment that could significantly increase in value after a liquidity event.
   Note: *Depending on the employee's band (seniority), there may be requirements to hold a certain amount of the stock.*

The W-2 wage component is determined differently for each form and type of grant:

- When exercising a nonstatutory stock option (NSO), the spread (difference) between the exercise price and the fair market value is W-2 income subject to federal, state and local income and payroll tax.
- When an incentive stock option (ISO) is exercised, that action alone does not trigger W-2 income or associated income and payroll taxes. But the spread is taxable income in the alternative minimum tax (AMT) system.
- When an RSA vests, the fair market value on the vesting date is added to W-2 wages (unless an 83(b) election is made within 30 days of the grant, in which case it is the FMV at the grant date). For RSUs, it's the FMV on the date the stock is delivered. If an IPO occurs near year end, payroll tax may apply the year the IPO takes place. But the income tax occurs the following year when the stock is delivered.[1]

The cost basis of the stock on an ISO exercise is the exercise price in the standard tax system and the FMV in the AMT system. When exercising an NSO, the cost basis is the FMV of the stock at exercise. For an RSA or RSU, the cost basis is the FMV at constructive receipt of the stock (unless an 83(b) election is made within 30 days of an RSA grant, in which case it is the FMV at the grant date).

Note: *See below for unique tax treatment for ISOs and restricted stock.*

[1] A double restricted RSU with an IPO liquidity event could be subject to payroll taxes in the calendar year the risk of forfeiture is lifted and subject to income tax in the following calendar year if that is when the stock is delivered.

COMMON QUESTIONS

Q: How will I know if I receive an equity grant?

A: You will receive an award letter or certificate detailing the type/form of the grant, the number of awarded options, shares or units, the vesting schedule and any expiration period. The grant letter usually includes rules for the specific grant. There's often a broader overall stock plan document as well. Your company may have a website where you can review your grants.

Q: If I receive a grant, am I guaranteed to acquire the company stock?

A: You must be an employee of record when the grant vests, but there can be exceptions for change of control, death or disability. For an ISO or NSO, you must exercise the option to acquire the stock.

Q: How is the amount of W-2 income determined when I acquire company stock through a grant?

A: ***Example of restricted stock grants:*** A restricted stock grant vests 5,000 shares at $0.40 a share in FMV. 5,000 shares x $0.40 a share = $2,000 in compensation added to your W-2 income for the year. For RSAs, the granted stock is placed in an escrow account, and you acquire it as it vests. The company plan may permit an 83(b) election, which allows payment of taxes on the FMV at the grant date rather than the various dates when shares are no longer escrowed.

Example for option grants: An NSO with an exercise price of $0.10 x 2,000 exercised options at an FMV of $0.40 per share. The spread is $0.30. Then, $0.30 x 2,000 shares = $600 in compensation added to W-2 income for the year. If it's an ISO, there is no W-2 income due to exercise, but there is $600 in AMT income. There is a cost of acquisition. In the example, the $0.10 exercise price x 2,000 options = $200 in acquisition cost.

Note: Your company may offer several ways to cover acquisition cost and/or withholding; cash, a loan and/or a stock swap using shares you already own. Less common before an IPO is a net exercise where shares are sold to cover the withholding and acquisition, and the net is delivered as the remaining shares.

Q: If I acquire company stock through a grant, does the company withhold taxes?

A: Yes. A minimum of 22% withholding is required for federal taxes unless the value is more than $1 million where required withholding for the portion above $1 million is 37%. A company will generally withhold for state income tax and applicable payroll tax. Your employer may offer you ways to keep more shares (see above) or require you to cover tax withholding in cash or from paycheck withholdings.

Q: What is an early exercise?

A: Sometimes called a reverse exercise, an early exercise is when the plan permits the exercise of options that haven't yet vested. Pre-IPO companies may offer this option in the earliest or all pre-IPO option awards.

Q: What is an 83(b) election?

A: Filing an 83(b) election with the Internal Revenue Service within 30 days of an RSA grant or the early exercise of options enables the grantee to incur the tax burden and initiate the long-term capital gain holding period ahead of the vesting schedule. The goal is to lessen tax friction of a presumably rising stock valuation by paying taxes on the RSAs grant date or by exercising options early — when the spread between the exercise price and the FMV of the stock is very narrow. The downsides are taxes on an asset where there is risk of forfeiture (does not receive the stock) and a lower stock price at vesting.

Q: What is the difference between cliff and graded vesting?

A: Cliff means "all at once" vesting at a point within or at the end of the vesting schedule. Graded means partial vesting in scheduled increments. Grants can have an element of both, starting with a cliff period and followed by a graded schedule. This is common in pre-IPO companies. Also possible in a pre-IPO company is an immediate grant. That means the recipient receives the stock at award with no vesting period.

COMMON QUESTIONS (CONTINUED)

Q: How are things different in an equity compensation plan between a publicly held company and a pre-IPO private company?

A: There are several things that differ.

	Pre-IPO company	Publicly held company
Liquidity	▪ Stock is illiquid (limited ability to sell). There can be an opportunity to sell the stock in a private sale before the company goes public. This opportunity is rare and if offered the window is short (30 days). The offer often involves a sale price at a premium above the current FMV of the stock	▪ Stock is listed on a public exchange
Sales restrictions	▪ Post-IPO lockup period of 3–6 months ▪ Required company buybacks	▪ Holding requirements for executives ▪ Company-imposed blackouts
Options	▪ Incentive stock options and nonstatutory options ▪ Some grants offer early exercise of options before vesting	▪ Nonstatutory options are common ▪ Stock appreciation rights are less common ▪ Only vested options are exercisable
Restricted stock	▪ RSAs and RSUs are used ▪ RSUs can have a double restriction, time vesting and an event (change of control or an IPO) ▪ Stock delivery after the restriction is lifted varies from plan to plan ▪ The RSUs may have an expiration period where the grants are forfeited if double restriction is not met	▪ RSUs have become the type of award in public companies, with RSAs in a diminished role ▪ Time vesting alone is most common with stock delivery soon after vesting ▪ Executive employees may receive performance share units with three-year cliff vesting where a performance measure must be met to receive the stock, cash or a combination of both ▪ PSUs grants have evolved from one format — fixed. Fixed is all or none based on if the measure is achieved. A new format is variable where the grant amount is 100% of the performance goal, but based on how well the performance metric is met, the recipient could receive as much 200% of the grant amount or as little as 0%

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