FRAMEWORK

GUSTO

CRASH COURSE

Offering equity to your employees

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A foreword from our CEO

When Eddie, Tomer, and I first started Gusto, we discovered something special: responsibility is exhilarating.

Being owners gave us courage and a long-term mindset that suddenly brought things within reach. We realized that while company founders are owners, more importantly, so is the team. Igniting a true sense of ownership — the type that rallies the whole team around a single mission — starts with one's equity stake in the company.

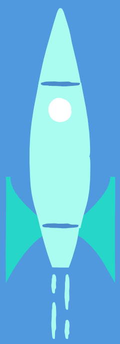
Every person that joins your company sets the foundation for the future, especially in a growth environment where change is the one constant. Clearly articulating your values through your job offer helps you find alignment with those who already possess the ownership mindset that you seek. And to truly empower your team, it's important that you give them the information they need to understand the upside of what they're building.

The thing is, getting equity right is really, really hard.

As devout believers in the power of ownership mentality, we decided to provide founders like you the insights you need to build amazing teams and get equity right from day one. And while the goal isn't an exit or an IPO, we think it's critical for your team to be invested in the journey ahead. We hope that this toolkit will also help you question common assumptions and ways of doing things. Even though no two companies are the same, there are best practices that we can all learn from.

In this guide, we'll show you how to use equity to bring out the values that make your company unique. We'll explain the basics, call out a few common approaches, and talk through the philosophies behind them. When you're finished, we hope you'll have the knowledge you need to roll out an equity plan that's in line with your business model, growth goals, and of course, the core values that drive how you're building your business and your team.

JOSHUA REEVES
CEO & CO-FOUNDER



INTRO

Get ready for takeoff

After a series of big ideas and sleepless nights staring at the stars, you and your co-founders finally have the blueprint and funding you need to launch. The next step? Hiring a stellar team to fly your rocket ship up and to the right.

Whether you're looking for employee number one or 15, the best way to hire people with the right stuff is to take them with you on your rocket ride. This guide will show you how to get your team on board. We won't tell you exactly how much equity to give your employees or how to structure it (that's ultimately up to you), but we'll point out some of the strategies and ideas you can use to chart your course. You're steering the ship: we're just your map of the stars.

A quick disclaimer

We've got two quick notes, young Jedi. First, tax laws constantly change. While this guide attempts to summarize the laws of today, they may shift tomorrow like the sands of time. To avoid pitfalls, consult your tax advisor.

Second, this guide covers equity basics, but there's much more complexity in the tax and legal universe. Our goal is to beef up your knowledge, since these decisions have such big implications for your team. But ultimately, you need to consult your attorney and tax advisor when structuring your equity strategy.

"Difficult to see. Always in motion is the future."

YODA

PART 1

Why equity matters

Before we hit full throttle, let's take a step back and ask "why."
It's important to consider exactly why you're issuing equity.
Your answers will inform the specifics of your offer.

Why offer equity to your employees?

There are four main reasons you may want to give your team equity:

1. To help you hire top talent:

   Talented candidates are taking a big risk when they come work for you. An equity stake gives them a shot at getting a big reward.

2. To hang onto your best performers:

   Want your team to stick around? Incentivize each employee to grow with the company by granting equity that vests over time.

3. To develop an ownership mentality:

   When employees are actual owners, they'll be more committed to the long-term health of the company.

4. To keep money in the bank:

   You might not have the cash flow to meet market-rate salaries of top talent just yet. Equity can keep you competitive.

While granting equity isn't quite rocket science, it does require a careful balance of these competing drivers to ensure your team feels valued, motivated, and inspired to do incredible work. We'll call out a lot of common practices, but we encourage you to view them with a critical eye. No two companies are the same, and their equity packages probably shouldn't be the same either.

"It's easy to feel that equity is mechanical and dry, but it's important to understand the details. Your founding team should put in the effort to learn how various options work and, crucially, the long-term tax implications for your employees down the line. If your company is successful, this thoughtfulness will have a huge impact for your employees. It's worth it to question many of the default equity set-ups, and instead make sure you set something up that is in line with your company's philosophy."

BEN EIDELSON • CO-FOUNDER AND CEO OF MENSCH LAB

PART 2

Key terminology

You should lean heavily on your lawyer and accountant for navigating this particular asteroid field. But as you're powering up your engines, here are some terms you'll need to know to map your flight path.

Let's talk stock

When it comes to employee equity, there are two types of stock you should understand well enough to describe to your early employees:

Preferred Stock

Preferred Stock is typically sold to investors.

This type is called "preferred" because it has additional rights attached to it, like voting on certain corporate governance matters and selecting board members. Preferred Stock is also first in line for payout, which is known as a liquidation preference; upon an exit those who own Preferred Stock are typically paid out first (before those who own Common Stock).

Common Stock

Common Stock is for employees (though some investors buy Common Stock too).

Since Common Stock doesn't have additional rights or liquidation preference, it's seen as less valuable (while the company is still private) and it's priced at a discount to the Preferred Stock. When a company goes public, Preferred Stock is typically converted into Common Stock. The result is one type of stock, with one price, that anyone can buy or sell on a public stock exchange.

Gravitating towards grants

In this section we'll focus on Common Stock, since it's earmarked for your team.

There are two common ways to grant Common Stock to employees: through **stock options** or **restricted stock.** As an early-stage startup, stock options are by far the most common way to grant equity to employees. However, it's important for you to understand the alternative so you can make the best possible decision.

Stock options

Stock options are the right (or option) to purchase stock in the company at a specific price, which is called the **exercise price,** or the **strike price.** Just for clarity's sake — stock options aren't stock; they have to be purchased (or exercised) first.

Restricted stock

Restricted stock is the right to own stock, with specified restrictions. Once the conditions of the removal of the restrictions have been met, which could be fulfilling predetermined performance goals or staying with the company for a specified period of time, the restrictions are lifted and the employee fully owns the stock.

A NOTE ON RESTRICTED STOCK

Restricted stock can be purchased at the fair market value or granted outright. As a warning: If the stock is granted (without the employee purchasing it), then that person will need to pay taxes on the stock when it vests, which can be very expensive. Don't worry, we'll get into the tax stuff in Part 3.

Venturing into value

How is Common Stock valued?

The price of Common Stock is determined through something called the **409A process.** During this period, you'll hire an outside firm to evaluate your company's financials and market data to determine the value of your common stock. According to the IRS, the 409A valuation needs to be refreshed at least once a year (and more often if there's a significant financial event like fundraising).

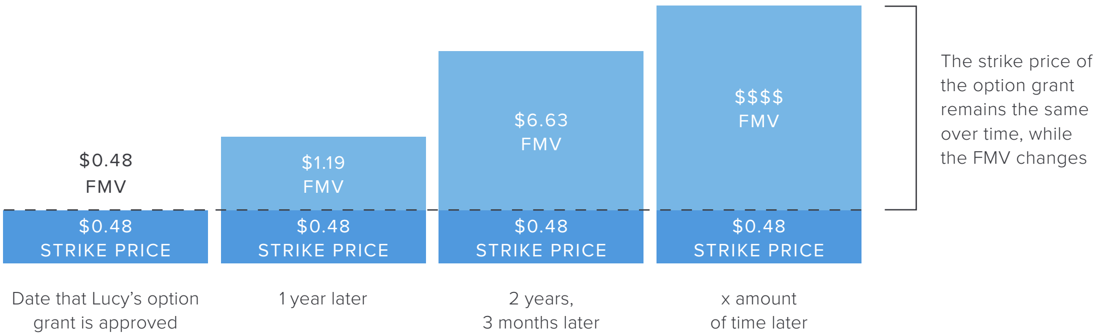
The exercise price, or the **strike price,** doesn't involve a workout or a walkout (sorry, we couldn't resist). It's what employees must pay to take ownership of the stock. Each employee option grant that is issued has its own exercise price, which is the **fair market value (FMV)** of the Common Stock on the date the grant is approved by the board.

Stock options can become extremely valuable because the exercise price of an employee's option grant is fixed. When the value of your high-flying startup rises, the value of the stock increases with it. If everything works out according to plan, the fixed exercise price will likely represent a big discount when employees exercise their options.

If the employee is issued more options at a later date (after a promotion, for example), the new options will have their own exercise price, which is the FMV of the Common Stock when it's approved by the board.

LET'S PLAY THIS OUT FOR A SECOND

Say Company X (not to be confused with actual rocket builder Space X) hired a rockstar engineer named Lucy a few years ago. The exercise price for Lucy's stock options was set at $0.48 per share, based on the FMV at the time she started. As time catapults forward, Company X becomes a smashing success and the FMV (as determined by the periodic 409A valuations) grows well above Lucy's exercise price:



Assuming Lucy's options have vested, they give her the right to acquire stock for a small fraction of its value. Keep in mind that the difference between Lucy's FMV and exercise price becomes taxable when she exercises her options. More on that in Part 6.

Unveiling vests and cliffs

When you grant stock options or restricted stock to employees, it's standard to give it out in installments over time. Breaking down grants into installments brings two more concepts to light:

Vesting

Vesting is not just a smart fashion decision — it also means gaining the right to exercise the stock. A vesting schedule lays out the timetable in which an employee gains the rights to the options. Linear vesting is the norm, which translates to the same amount of stock vesting periodically, whether that's every month, quarter, or year.

Cliffs

A cliff is a milestone when the first portion of the stock vests, meaning the employee doesn't get the rights to the options until the cliff. Most companies have a one-year cliff.

LET'S PLAY THIS OUT AGAIN

To explain further, let's bring Lucy back into the picture. Company X offered her options with a four-year linear monthly vesting schedule. Her grant also has a one-year cliff. With this schedule, Lucy's options would be fully vested after four years of being with the company. After one year (once they've passed the cliff), 25 percent of her options will be vested. If Lucy were to leave after 11 months, none of her options would be vested. If she were to leave after exactly 24 months, then 50 percent of her options would be vested — 25 percent after year one, then 1/48th over each of the 12 months following her initial cliff.

Why don't we just ditch the cliff and vesting schedules all together? More stock for all!

Great question. But hold up, space cowboy. Cliffs and vesting schedules are standard for a few reasons:

1. They are in line with a person's growing contributions to a company over time. When a stock option grant is given at the start of employment, that young buckeye hasn't done the work to earn it yet. Vesting ensures that the maturing maverick gets equity commensurate with their time at the company.

2. They ensure the employee is a good fit for the company. If you or the employee decides the company isn't the best place for the employee, you haven't given away loads of equity.

3. They incentivize people to make a long-term investment in your business by rewarding them with equity over time.

One more thing to note: if you have accelerated vesting schedules or no cliffs, investors will often ask you to adjust both to a more standard structure when you receive financing. Founders should also consider having vesting schedules; this is something that investors expect, too. It signals to all partners (employees, investors, and more) that the founders are in it for the long haul.

PART 3

Building your equity strategy

Now that you understand all the tools and levers, let's use them to bring in employees that will make your company take flight. If you feel like you're floating through space, don't worry. We won't leave you on Mars like Matt Damon.

STEP 1

Plan your dream team

Who are the crucial hires that will take your company to new altitudes over the next 12 to 24 months? Once you sketch it out, you'll want to solidify a hiring and recruiting plan that takes into account the timing of your next round of funding.

CHECK OUT:

- Use our hiring email templates to make the process a snap.
- Get a jumpstart to hiring your first employee with this in-depth guide.

"Have a plan for how many people you plan to hire in the next 15 to 24 months and have an estimate for a low and high equity range for each role. This will prevent you from making one-off decisions case by case as you hire people."

LYNN PERKINS • CEO AND CO-FOUNDER OF URBANSITTER

STEP 2

Carve out your equity pool

Next, set aside a percentage of equity for your initial group of talent. Philosophies vary on how much to set aside.

With your hiring plan in hand, ask yourself these three questions:

- [ ] How many people do you want to hire? As a rule of thumb, the more people you employ the larger the employee equity pool should be.
- [ ] How senior are your hires? More senior or technical hires that are in high demand typically receive more equity, so you'll want to cut out a larger slice.
- [ ] When is your next round of financing? Each time you raise funding, you'll issue new shares to investors. At the same time, you'll likely increase the size of the employee equity pool for additional hires post-financing.

If you had eight people in a five-person jacuzzi, you'd probably want a bigger hot tub, right? The same goes for your equity pool: you'll want to increase the size of your pool as you add more employees. Every year you might want to evaluate the remaining size of your pool and increase it by several percentage points, likely between three to five percent. Remember, your board and stockholders have to approve the size each time this happens. It's best practice to manage your pool like you would a budget, saving some equity for bigger hires that come up down the road.

> **BEWARE DILUTION**
>
> Just remember, every time you increase the pool, you dilute ownership. Each person in that pool now owns a smaller percentage of the company.

CHECK OUT:

- Quora has a treasure trove of recommendations from seasoned founders.
- Venture Hacks' article, "The Option Pool Shuffle," details how to create an option pool from a hiring plan.
- Venture capitalist Fred Wilson proposes his own formula for sizing option pools for investors and future employees.
- Y Combinator's Sam Altman wrote a convincing piece on offering more equity to employees, which spurred a healthy debate on the matter. It's worth a read.

"It's easy to start giving equity away on a first-come, first-served basis without thinking about the CTO or CMO that's on your to-hire list, and before you know it you've run through the employee option pool. It's better to plan ahead, reserving equity for key hires and being mindful that you'll want to hire some senior employees (who require significant chunks of stock options) down the line."

KEVIN BARENBLAT • CO-FOUNDER OF FAST FORWARD AND CONTEXT OPTIONAL

STEP 3

Research competitive salaries and compensation

Once you've got your list of key hires together, do some research on salaries and equity norms for those roles. Since you probably don't have a ton of resources at your disposal, it may be hard to get your hands on competitive data — but a little scrappiness can go a long way. Ask your founder friends or investor pals, and check out salary sites with free and low-cost subscription services. Here are a few places to get you started:

CHECK OUT:

- Angel.co provides a useful list of benchmark salaries and equity for startups.
- Glassdoor, Payscale, or Salary.com tend to provide salary data for larger companies. It's helpful to know what your employees are turning down to join your venture.
- Leo Polovets crunched some data on AngelList job postings, publishing a comprehensive analysis of salary benchmarks.
- Paul Graham's equity equation is worth considering while you estimate the current and future value of a candidate.

STEP 4

Set your vesting and cliff schedule

Sounds pretty adventurous, right? The standard approach is a four-year linear vesting schedule with a one-year cliff. But before you go with a vanilla vesting schedule, make sure it jives with the values and time horizons of your business. For example, some companies looking further down the road offer five-, six-, or even ten-year vests.

CHECK OUT:

- Entrepreneur Rob Fitzpatrick provides a beginner's guide to vesting.
- Andy Rachleff, who founded Wealthfront, outlines the benefits and considerations of vesting stock options.
- Sam Altman's piece on employee equity covers this topic as well, proposing perspectives on alternative vesting schedules.

STEP 5

Stock options or restricted stock?

For early-stage startups, granting stock options is usually the way to go. If you're considering issuing stock straight up, it's good to be aware of the tax implications for your employees.

Granting stock options lets your team choose when to exercise. This choice gives them the privilege of waiting until they think their investment in the company will be worthwhile. However if employees are granted stock directly, this choice evaporates. They'll own the stock as soon as it vests, possibly triggering, gulp, thousands of dollars in taxes. If the stock can't be sold because the company isn't public yet, paying those taxes can be a tall order.

In a nutshell? If you're gung-ho about granting alternative forms of equity, make sure that your employees are too.

GET THAT BOARD APPROVAL

Make sure your board approves the equity grant for every single employee. An employee's exercise price is locked in at the FMV upon approval of the board. If they don't approve the grant, it doesn't exist!

CHECK OUT:

- The National Center for Employee Ownership breaks down the tax implications of options vs. restricted stock.
- Finance guru Andy Rachleff also wrote a smart article on the topic.

STEP 6

Plan for grants and promotions

If you plan to keep your team around for the long haul, you'll want to build a promotion structure for star performers. Will you grant employees more equity for a stellar performance? Or after two years? How about when they're promoted? A formalized plan will help motivate your team and enable you to plan for future stock option allocation.

One founder we talked to viewed adding equity in more straightforward terms: "Be sure you're continuing to reward your team members as they grow with your company. Four years is a long time to fully vest; it can be the entire lifecycle of a startup. As employees take on new roles and own more responsibilities it's important to compensate them for their contribution. They have domain expertise and tenure, and their equity stake should reflect that."

CHECK OUT:

- Wealthfront's employee equity plan is worth reviewing in detail, both to see a particular philosophy in action and the math behind calculating employee equity. Promotions are a big part of why this plan is plain awesome.

STEP 7

Set an expiration timeline

When an employee leaves, when should their stock options expire? The standard expiration is three months after someone terminates their contract, but that trend is slowly changing. Many think it isn't fair to force employees — especially those who don't have large savings — to exercise their options before they're ready for a potential financial burden. A longer expiration timeline can allow your team to exercise when they have a more substantial income or when stock becomes liquid after the company goes public.

While providing more flexibility is great for employees, there are significant administrative strains if you offer an extended expiration timeline. They're a bit convoluted, but here's a quick explanation:

The US tax code provides two types of stock options: ISOs (incentive stock options) and NSOs (non-qualified stock options). In short, ISOs can only be issued to employees. They have special tax benefits because they're meant to be used as carrots for employees. NSOs are for anyone, including employees, contractors, and investors.

Why do these matter? ISOs expire three months after an employee leaves a company. That's why the standard expiration for options is also three months.

So, if you'd like to let your team exercise more than three months after leaving, you can convert their ISOs to NSOs and set a new expiration timeline. While this favors your employees, managing the switch means more work for your legal and accounting teams. You'll also increase the number of option holders who are not employees, which isn't ideal. It's up to you to weigh the pros and cons and figure out if offering a more flexible exercising timeline is core to your company's values.

CHECK OUT:

- Startup Lawyer has a great post outlining the differences between ISOs and NSOs.

STEP 8

Decide if your employees can exercise early

Exercising early simply means that you allow employees to exercise before their equity has vested. Even if they become early (exercise) birds, they won't own their stock until it's vested. The benefit to exercising right after receiving an equity grant is that the employee's exercise price is valued the same as the company's Common Stock (i.e. the current FMV), which means they are not responsible for any taxes that year (or until they eventually sell the stock).

But in order to not be responsible for taxes, employees must file an 83(b) election within 30 days of their early exercise date. They'll also need to file the election with their taxes that year. The 83(b) election is a document notifying the IRS that someone has early exercised and that the difference between their exercise price and the FMV is zero, and therefore they do not owe any taxes on the transaction.

Again, many early-stage startups don't allow employees to exercise early. Nonetheless, it's worth knowing that offering the ability to early exercise is a possibility. Consider the pros and cons and decide what's right for your company. Your equity offer is a reflection of your values as founders and as a company.

The pros

Early exercise can provide a bunch of tax benefits for employees (more detail in Part 6). Exercising early also means your employees become stockholders, which cultivates a strong sense of ownership.

The cons

It can create extra accounting and administrative work for your company. If an employee exercises early but leaves before their stock has fully vested, you'll have to manage a repurchase process, which is its own delectable can of worms.

CHECK OUT:

- Quora discussions on the pros and cons of offering the option to exercise early.
- Startup Lawyer's post on the difference between ISOs and NSOs is super helpful for understanding this issue, too.

STEP 9

Give yourself a hug

Nice job — you now know how to put together the equity package your future employees are dreaming of. Piloting your rocketship won't always be easy, but when you reach a difficult milestone, you deserve to celebrate. These animals will give you a head start:

CHECK OUT:

- 25 cute animals hugging — it's exactly what it sounds like.

Read on for advice from founders who have successfully propelled their companies into orbit.

Build a team of owners

"As a founder, the right thing to do is to treat your employees like true owners of the business. At Gusto, this means offering employees the ability to early exercise so they can leverage the tax benefits. It also means that we allow folks to exercise up to 10 years after leaving the company, as long as they were a part of Gusto for at least two years. This way, employees aren't constrained by "golden handcuffs" — they don't stay simply to keep their stock options, and they're not forced to spend money (which they may not have) exercising within three months of leaving. Our goal is to put the power and flexibility into the hands of our employees. The standard equity packages are slowly changing, and we're excited to be part of this new wave of treating the employee as a true owner of the business."

JOSHUA REEVES • CO-FOUNDER AND CEO OF GUSTO

PART 4

Advice from entrepreneurial test pilots

We reached out to our favorite entrepreneur and investor buddies, both experienced and new, to share their ideas and wisdom. We also lassoed in quotes from leading mavericks of our day, who have influential articles on equity.

Here's how they made these tough decisions (and what they'd do differently).

Help your employees gain the upside of your company's value

"When you start building an equity program, one thing to consider is what are some things you can do to make it easier for your employees to participate in the upside of the value they're creating. For example, allowing early exercise of grants helps employees with the tax impact of vesting events. Recently some founders are also reviewing the standard "90 days to exercise" clause for exiting employees and increasing that timeframe to provide departing employees with more of a window to work out the financial implications of their ownership."

HUNTER WALK • PARTNER AT HOMEBREW (SEED STAGE VENTURE CAPITAL)

Consider granting more equity to your first employees

"It's important to value your earliest employees, and equity is one obvious way to do that. It's a competitive hiring market and people have a lot of options. They are taking on just as much risk as you are by joining your company, but often not gaining as much upside as the founders. It's important to understand the ins and outs of equity in all its complexity so that you can help your employees benefit from the potential success of what you're building together."

NAFIS JAMAL • CTO OF MOPUB (ACQUIRED BY TWITTER)

Educate your team about equity

"Not everyone knows or understands it, and many people (even those in Silicon Valley) won't necessarily value it. Make sure to explain simple yet esoteric things like 'fully-diluted shares' and liquidation preferences, but also more complicated concepts like 83(b) elections, 409A valuations and the difference between different kinds of stock options, if applicable."

ROB LEATHERN • FOUNDER AND CEO OF OPTIMAL.COM

Offer multiple compensation package options

"When you're making a job offer, walk the candidate through a few different compensation packages with various mixes of salary, equity, bonuses, and benefits. You may not know what the candidate cares most about, and their feedback will help you learn more about their motivations. If someone wants more salary and less equity, they may be more short-term minded. If they opt for more equity, they could be big believers. Everyone's calculus obviously changes based on their personal financial situation and stage of the company, but having a holistic discussion is a great way to find a flexible solution."

AMIR MALAYERY • FOUNDER OF DAPPER AND VP AT INDUSTRY VENTURES

Estimate the value of your equity with the formula: 1/(1-n)

"Whenever you're trading stock in your company for anything, whether it's money or an employee or a deal with another company, the test for whether to do it is the same. You should give up n% of your company if what you trade it for improves your average outcome enough that the (100 - n)% you have left is worth more than the whole company was before."

PAUL GRAHAM • CO-FOUNDER OF Y COMBINATOR

Tell prospective employees their percentage of ownership

"Most startups do a bad job of helping employees think about the value of their options. At a minimum, any startup should tell a prospective employee what percentage of the company the equity grant represents (number of shares is meaningless). [...] Employees should demand to know what percentage of the fully-diluted shares their stock options represent."

SAM ALTMAN • CO-FOUNDER OF Y COMBINATOR

Equity: It's both an art and a science

"For your first key hires, three, five, maybe as much as ten, you will probably not be able to use any kind of formula. Getting someone to join your dream before it is much of anything is an art not a science. And the amount of equity you need to grant to accomplish these hires is also an art and most certainly not a science. However, a rule of thumb for those first few hires is that you will be granting them in terms of points of equity (i.e. 1%, 2%, 5%, 10%)."

FRED WILSON • CO-FOUNDER OF UNION SQUARE VENTURES

*Photo courtesy of Joi Ito

The argument for standard equity packages

"Pick a standard investing time period. This could be something like ¼ of the shares vest after one year at the organization and the rest vest at 1/48 per month for the next 36 months. Having an industry standard vesting schedule will make it easier for potential employees to understand what they are being offered at your company and if you are looking to get institutional investment, the investors will require a standard vesting schedule. It's easier to create that upfront than to get employees to signed on to a modified plan down the road."

LYNN PERKINS • CEO AND CO-FOUNDER OF URBANSITTER

PART 5

Communicating the equity package: What your employees need to know

Now you're really ready for flight. Once you've put together your compensation packages, you need to communicate them effectively to your recruits. In this chapter, we'll cover how to make your pitch and what info should be in your offer.

Know your numbers and nail your pitch

Now that you're ready to offer a recruit, you should explain:

- What the total package is, including salary, equity, bonus, and benefits.
- How you arrived at that package, and how your values as an organization are reflected in your numbers.
- How this offer is competitive and compelling.

To expand on the last bullet point, show your employees that you have done your research and that you know how your offer stacks up against the market.

Provide the details your hires need

Be prepared to answer all kinds of questions employees may have about their offer. Transparency is attractive; it signals to your employees that they can trust you. Providing information upfront allows them to make the right choice for themselves, which benefits you too.

It's ultimately your call on how transparent or opaque you want to be. Whatever you decide, here are a few numbers you might want to think about revealing — many of which candidates will expect:

- [ ] Number of options being granted
- [ ] Private valuation of the company
- [ ] Employee's anticipated strike price, with the caveat that it may change based on the 409A valuation
- [ ] Price of Preferred Stock **
- [ ] Total number of shares that exist in the company **
- [ ] The percent of the company being granted **

THE INFO YOU SHARE SHOWS YOUR VALUES

**The price of the Preferred Stock, number of total shares, and the percent of the company can be a touchy subject that some companies are hesitant to bring up. Just remember that the information you share with your team is an extension of your values as a company. If you value transparency, then you should proactively share information about your company's financials and your employee's equity package.

PART 6

Tax time: A basic guide for your employees

Your crew is assembled, and your ship is gaining altitude. We're getting closer. It's time to continue our equity journey by diving into the basics of exercising and selling one's hard-earned stock.

Exercising and selling

Though the value of your stock may be soaring, exercising and selling can cause some turbulence, especially when it comes to navigating the different types of taxes and regulations out there. If you really want to help your employees enjoy the upside of your success, it's critical that you both understand the potential tax implications of exercising and selling. And that's just what this chapter will cover.

But one big disclaimer: We can't recommend when an employee should exercise or sell. Exercising is a person's individual right; if and when they exercise is ultimately up to them. Your employees should evaluate their own finances, consult their tax advisors, understand the equity packages, and assess the viability of the company before spending their own money on stock.

EMPLOYER BEWARE

Employees aren't the only ones that need to be aware of tax implications with stock. There are lots of different tax consequences for the employer, like taking deductions on certain stock issuances. So once again, make sure you've got a real Einstein of an accountant, as they've got lots to process!

Quick tax facts

As an employee, you can be taxed upon two transactions: when you exercise your stock options and when you sell your stock. Just how much you are taxed depends on a few factors:

When you exercise, your tax bill depends on:

1. Whether the stock options are ISOs or NSOs, since they're taxed differently.

2. The difference (also called the spread) between your exercise price and the FMV. The greater the gain, the greater your taxable income.

When you sell, your tax bill depends on:

1. The difference between your stock basis and the FMV upon selling. Again, the greater the gain, the greater the taxable income amount.

2. The length of time you hold the stock before selling, which triggers either short- or long-term capital gains tax rates.

3. For ISOs, whether or not you meet the requirements in order to

HOLD UP, WHAT'S "STOCK BASIS"?

The stock basis is two things added together: It's your exercise price plus anything you've recognized as taxable income upon exercise.

qualify for long-term capital gains rates. If you don't meet them, you might be subject to ordinary income tax rates.

NSOs vs. ISOs:

When you exercise stock options, you're subject to two independent tax systems: regular income tax and alternative income tax (AMT). NSOs and ISOs are affected by these systems differently. Below is a broad overview of both types of options, and the types of taxes that may impact you upon exercising, holding, or selling your stock.

WHAT'S WITH THE AMT?

The AMT is a supplemental tax system that kicks in when certain taxable events (like exercising options) don't trigger enough taxes in the government's eyes. Depending on your personal finances and income, ISOs may require you to pay the AMT.

NSOs:

- ✓ NSOs can be granted to anyone, including employees, contractors, advisors, and more.
- ✓ NSOs are taxed upon exercise and are subject to ordinary income tax rates.
- ✓ NSOs are not an AMT adjustment item.

ISOs:

- ✓ ISOs can only be granted to employees.
- ✓ ISOs are not taxed upon exercise.
- ✓ Exercising ISOs may trigger the AMT, depending on your personal finances. If the AMT is triggered, then you may be taxed upon exercise.
- ✓ Now, since ISOs have special treatment (i.e. they are not taxed upon exercise and can qualify for lower tax rates), there are two extra requirements you need to meet. You cannot sell stock within:

    1. Two years after the original ISO was granted, or
    2. One year after the ISO was exercised.

    This is super important. In tax-speak, not meeting either of the requirements is called a "disqualifying disposition," because you're disqualified from the favorable tax treatment. And a disqualifying disposition means that you won't qualify for long-term capital gains rates. Instead, the gain on your sale will actually be subject to ordinary income tax rates, which are higher and therefore less favorable.

Types of taxes:

Here are the major types of federal taxes that are triggered when you exercise or sell stock:

Taxes	Tax rates	ISO	NSO
Income tax	Capped at 39.6%, as of this writing	Does not apply unless there's a disqualifying disposition	Applies
Alternative Minimum Tax (AMT)	Depends on your tax bracket and personal finances (including property taxes, medical expenses, and more).	AMT adjustment item	Not an AMT adjustment item
Long term capital gains	Capped at 20%, as of this writing	Long-term capital gains rates apply unless there's a disqualifying disposition	Long-term capital gains occur when the stock is sold more than one year after it was exercised
Short term capital	Capped at 39.6%, as of this writing	Does not apply unless there's a disqualifying disposition	Short-term capital gains occur when the stock is sold less than one year after it was exercised

And as a note, capital gains may also be subject to a thing called the Net Investment Income Tax. You (and your employees) should consult a tax advisor to see if that applies.

The table on the previous page provides basic descriptions for each type of tax, but there's way more nuance and complexity. For a deeper dive you'll want to do more research and rely on your tax and legal advisors. Meanwhile, below are some resources from tax pros to get you started.

CHECK OUT:

- The Tax Foundation lists the latest income tax brackets.
- Does the AMT apply to you? The IRS has an AMT calculator to help you figure out just that.

Putting it in action:
Exercising options and selling stock

To give you a better sense of the outcomes your employees can expect, here are a few common scenarios. As you can see, changes to the company's value and timing can have big tax implications.

	Scenario 1: When the FMV is the same as the exercise price	Scenario 2: When the FMV is higher than the exercise price	Scenario 3: At IPO, when the FMV is higher than the exercise price
Taxes if NSO	Upon exercise: (No tax) Upon sale: Long term capital gains, if the investment is held for more than 1 year	Upon exercise: Income tax on the difference between FMV and the exercise price Upon sale: Long term capital gains, if the investment is held for more than 1 year	Upon exercise: Income tax on the difference between FMV and the exercise price Upon sale: Short term capital gains, if the investment is held for less than 1 year
Taxes if ISO	Upon exercise: (No tax upon exercise) Upon sale: Long term capital gains, unless there's a disqualifying disposition	Upon exercise: AMT if applicable Upon sale: Long term capital gains, unless there's a disqualifying disposition	Upon exercise: (No income tax) AMT if applicable Upon sale: Long term capital gains, unless there's a disqualifying disposition

If the chart above feels a little abstract, on the next few pages we've outlined each scenario in more detail, with Lucy's help.

SCENARIO 1

When the FMV is the same as the exercise price

DESCRIPTION:

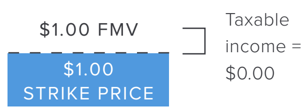
This scenario mainly applies to folks who early exercise. It could also apply if the FMV is the same as an employee's exercise price after their stock has vested.

For early exercisers, the idea is to exercise before the valuation changes. Within this narrow window of time, the stock options that the employee has received are priced at the same value as the Common Stock of the company. In other words, the difference between the FMV and the exercise price is zero. As a result, they can exercise their options and have no tax bill that year because there's no difference between what is paid and what it's worth. As an example, your employee, Lucy, would pay $1 for something worth exactly that — $1.

NSOs:

- **Upon exercise:** Since the difference between the FMV and the strike price is zero, no gains are subject to taxes upon exercise.
- **Upon sale:** The difference between the FMV and her stock basis is subject to capital gains. If Lucy holds her stock for over one year before selling, she qualifies for long-term capital gains rates.

Scenario 1



ISOs:

- **Upon exercise:** ISOs are not taxed upon exercise, as long as there aren't any disqualifying dispositions. Additionally, since the difference between the FMV and the strike price is zero, no gains are subject to taxes upon exercise, even if Lucy did disqualify.
- **Upon sale:** Remember, in order to qualify for long-term capital gains, Lucy needs to make sure she doesn't have a disqualifying disposition. It's the difference between the FMV and her stock basis that's subject to taxes here.

FILE THAT 83(B) ELECTION

Employees who early exercise must file an 83(b) election within 30 days of exercising. The 83(b) election is a document notifying the IRS that someone has early exercised and that the difference between their exercise price and the FMV is zero, and therefore they do not owe any taxes on the transaction.

SCENARIO 2

When the FMV is higher than the exercise price

DESCRIPTION:

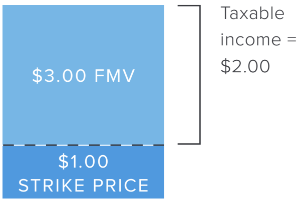
Assuming the company is appreciating in value, then the FMV is higher than the employee's exercise price.

Using the example above, let's say the Common Stock price has risen to $3. Since Lucy has stock options with an exercise price of $1, then she'll pay $1 for something which is now worth $3. The government sees that $2 gain as income, so Lucy might receive a tax bill at the end of that year.

NSOs:

- **Upon exercise:** If the options are NSOs, then the $2 gain will be subject to the ordinary income tax rate upon exercise. They are not subject to AMT.
- **Upon sale:** If Lucy holds her stock for over a year before selling, she qualifies for long-term capital gains.

Scenario 2



ISOs:

- **Upon exercise:** If the options are ISOs upon exercise, then that $2 gain is not subject to regular income tax. However, Lucy might be subject to the AMT.
- **Upon sale:** Once again, in order to qualify for long-term capital gains, Lucy needs to make sure she doesn't have a disqualifying disposition.

SCENARIO 3

At IPO, when the FMV of the stock is higher than the exercise price

DESCRIPTION:

Now, Scenario 3 is essentially the same as Scenario 2, but we included it because you now have a public market in which you can sell your stock. But keep in mind that if a company goes public, there's usually a 180-day lockup period before company stock can be sold on the public exchange. That's why many people wait to exercise until after that lockup is over.

In this example, let's say the stock price is now $10. Upon exercising, Lucy would spend $1 to get stock worth $10, so the government would see that $9 as a gain, and she might be taxed on it. To prepare for this, she could sell some of her stock to foot the tax bill. But that's up to her.

NSOs:

- **Upon exercise:** If the options are NSOs, then Lucy is subject to regular income tax on the $9 gains.
- **Upon sale:** If Lucy exercises upon IPO and then immediately sells, she'll be subject to short-term capital gain rates, since she is selling her shares within one year after exercise.

ISOs:

- **Upon exercise:** If the options are ISOs upon exercise, then that $9 gain is not subject to regular income tax. However, Lucy might be subject to the AMT.
- **Upon sale:** Remember, in order to qualify for long-term capital gains, Lucy still needs to make sure she doesn't have a disqualifying disposition.

To infinity and beyond!

Yay! You made it through the crash course without, well, crashing. Now you have the know-how, footing, and tools to build the team of your dreams and help them soar.
Good luck!!

Need help building your business?

We have tons of guides and advice in Framework, our resource center. But what we spend most of our time working on is making payroll, benefits, and HR easy for small businesses. See how we can help you:

Check out Gusto →