Advanced Planning

# Personal planning for start-up founders

A startup founder can help mitigate risks associated with founder's equity and set the stage for personal financial success by planning for the personal side of the liquidity event.

In today's world, pursuing your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

From Silicon Valley to Boston and virtually everywhere in between, we're in a golden age of startup businesses. Some of the industries where startups have flourished include technology, life sciences and social media, but startups are transforming virtually every sector of the economy. Startup founders are passionate about their businesses and willing to take great risks and fail. Many of these businesses are funded by venture capitalists and angel investors with the ultimate goal of being sold to a larger competitor or going public.

So much time and effort is spent growing the business and preparing for a liquidity event at the business level that the founder's personal planning often takes a back seat. This is unfortunate. While fortunes can be made through ownership of a single business, they can also be lost. By planning for the personal side of the liquidity event, both before and after the transaction, a startup founder can help mitigate risks associated with founder's equity (particularly income tax, estate and gift tax and concentrated equity risk) and set the stage for personal financial success. As they say, "failing to plan is planning to fail." Just remember how many rich startup founders of the dot-com boom in the late 1990s lost everything in the dot-com bust of the early 2000s.

At a certain point, the venture capitalists expect the business to be sold to a larger company or go public.

## Anatomy of a startup

Most startups begin life with a few founders, a business idea and a small pool of capital contributed by the founders, their friends and family. Knowing that they hope to seek venture capital funding as they grow, the business is typically formed as a C corporation (C corp) (to be able to take advantage of the tax benefits of qualified small business stock discussed below). The founders are issued restricted common stock (sometimes referred to as founders' stock), some or all of which is subject to a vesting schedule. An options pool is also set aside for employees. After the company has some success, it's able to attract funding from venture capitalists and angel investors (basically wealthy individuals and family offices). These investors receive preferred stock, which has preferential rights to the common stock. The preferred stock can be converted to common stock, thereby diluting the percentage ownership of the founders and employees.

If the business continues to grow, additional rounds of venture funding may occur. At a certain point, the venture capitalists expect the business to be sold to a larger company or go public. An acquisition of the business is far more likely than an initial public offering (IPO). The timeframe for the liquidity event typically ranges from five to 10 years following initial venture funding. Assuming everything works out as hoped, the liquidity event will result in a large payday for investors.

Along the way, there are certain traps for founders (particularly dilution of ownership through rounds of financing) as well as opportunities (including income tax mitigation through certain tax elections, estate tax reduction and windows to diversify out of a concentrated equity position).

## Planning prior to the liquidity event

1. **Putting together the team.** Startup founders are typically young and not wealthy. As such, they've rarely worked with outside professionals regarding their personal financial affairs. This will need to change as the business increases in value. Choosing a good CPA is the first step. Making sure tax returns are properly filed and tax elections timely made is extremely important. Next up is a trusts and estates attorney to make sure an estate plan is in place if the founder is hit by the proverbial bus. The attorney can

also help draft documentation regarding gifts to family members and charity. Finally, a startup founder should retain a qualified wealth manager. The wealth manager can help with financial planning, including modeling of making early tax elections in connection with equity holdings. For best results, the outside advisors would collaborate with each other regarding important decisions along the way, each bringing to bear his or her specific expertise.

2. **Importance of financial planning.** Financial plans, typically prepared by a financial advisor, can be important foundational documents in the personal planning of startup founders anticipating a liquidity event. A good financial plan begins with the long-term financial goals of the startup founder. Once goals are established, the plan will determine cash flow needs and wants going forward.

   These fall into three buckets. The first bucket relates to liquidity, which is basically the assets needed to maintain lifestyle. The second bucket deals with longevity—the assets needed to improve lifestyle. The final bucket pertains to legacy, which are the resources that may be used to improve the lives of others—either through gifts/bequests to family and friends or philanthropic contributions.

   A good financial plan will also help the founder manage restricted stock and equity compensation, including understanding company transfer restrictions, tax elections and liquidity necessary to pay taxes on equity transactions. Finally, the financial plan can deal with single stock diversification strategies and inform a proper investment strategy based on the founder's risk tolerance after the founder has become liquid.

3. **Basic estate planning.** Because many startup founders are young, it isn't unusual for there to be no estate plan in place. Startup founders can have significant paper wealth, which could pass without a will in place to unintended individuals. In addition, if the startup founder dies, any amounts over $11.18 million in 2018 (if he or she's single) will be subject to a 40% federal estate tax (and an additional state estate tax in several states). Paying the tax may be difficult if the stock is illiquid. As such, the founder should consider term life insurance to provide liquidity for any estate taxes owed.

   In addition, if the founder is married, life insurance may be required to provide income replacement for the surviving spouse until the startup shares become liquid. Finally, a good estate plan includes documents providing for what happens should the startup founder become incapacitated, including revocable living trusts, durable powers of attorney and appointment of healthcare agents.

A good financial plan will also help the founder manage restricted stock and equity compensation, including understanding company transfer restrictions, tax elections and liquidity necessary to pay taxes on equity transactions

### Startup equity compensation

Startups typically issue equity-based compensation to incentivize employees and give them the opportunity to share in the growth of the business and to align their interests with the interests of other shareholders. Equity-based compensation also helps preserve the startup's cash position. The types of equity-based compensation frequently used are restricted stock awards, restricted stock units, incentive stock options and nonqualified stock options.

**Vesting and change of control.** Virtually all equity-based compensation is subject to vesting. Vesting can occur over time or be based on a mix of time and the achievement of certain performance goals. Typically, vesting takes place over three or four years, with the first vesting date occurring on the first anniversary of the grant. Many equity compensation plans include change of control provisions, allowing for full or partial acceleration of unvested grants on a change of control of the company. This is known as "single trigger" vesting. Other companies use "double trigger" vesting, under which, if there's a change of control, vesting will accelerate if the employee is terminated without cause within a specific period of time after the deal closes (typically six to 18 months).

**Restricted stock awards.** Restricted stock is common stock that's sold or granted to a startup founder. It's subject to vesting and is forfeited if vesting requirements aren't satisfied. If restricted stock is granted, the grant isn't a taxable event. At the time of vesting, restricted stock is taxed on its fair market value (FMV) less any amounts paid for the stock. It's treated as wages and subject to withholding. Any future sale of the stock will be treated as capital gains or capital losses.

**Restricted stock units.** Restricted stock units (RSUs) are similar in most respects to restricted stock awards. The primary differences are twofold. First, although an RSU grant is valued in terms of stock, no company stock is issued at the time of the grant. Second, when vesting requirements are satisfied, the employee typically is given the choice to settle in stock or cash.

**Stock options.** A stock option is the right given by the company to an employee or consultant (the "option holder") to purchase company stock in the future at a fixed price (typically FMV at the date of the grant) and exercisable for a fixed period of time (typically 10 years). Like restricted stock awards and RSUs, options are subject to vesting. There are two different kinds of options. The first are statutory stock options known as "incentive stock options" (ISOs). The statutory requirements are set forth in the Internal Revenue Code, and if they're met, ISOs receive favorable income tax treatment. ISOs may only be issued to employees. The second type of stock options are known as "nonqualified stock options" (NSOs). Grants of NSOs may be made to not only employees, but also to directors and consultants. Unlike ISOs, NSOs don't provide special tax treatment to the recipients. Typically, there's no taxable event to the recipient on the grant of either ISOs or NSOs.

**Income taxation of ISOs.** On the exercise of ISOs, there's no taxable income recognized by the option holder. However, the spread (difference) between the strike price (price at grant) and the value of the stock at exercise is subject to the alternative minimum tax (AMT) (potentially at the highest rate of 28%). Any gain post-exercise of an ISO is treated as a capital gain as long as the required holding periods are met. The required holding periods are one year from exercise and two years from grant and the employee must have been employed on the date three months before the exercise date. If holding periods aren't met, a "disqualifying disposition" occurs, resulting in ordinary income taxation on the spread between the strike price and the value of the option on exercise. Only $100,000 of stock, based on the strike price, may become exercisable in any calendar year, inclusive of all ISO grants that have been made.

Any gain post-exercise of an ISO is treated as a capital gain as long as the required holding periods are met.

**Income taxation of NSOs.** NSOs are compensatory stock options that don't meet the statutory requirements for ISOs. Recipients of NSOs generally are taxed at ordinary income rates on exercise on the spread between the strike price and the value of the stock upon exercise. Post-exercise appreciation is taxed as capital gains (long-term capital gains (LTCGs) if held more than a year after exercise). Unlike ISOs, there are no limits on the value of NSOs that can be exercised by an employee, director or consultant each year. There are no AMT issues involved with the exercise of NSOs.

**IRC Section 83(b) election.** An election under Section 83(b) may provide significant income tax benefits to the holders of both stock options and restricted stock awards. Because there's no actual stock issued until vesting, a Section 83(b) election isn't permitted for RSUs. Section 83(b) allows a taxpayer to elect to be treated for income tax purposes as if he or she received vested, unrestricted property from the employer, thereby triggering immediate income tax liability, even if the stock is subject to a substantial risk of forfeiture. Why would the founder or employee make this election? Because it can result in a large income tax benefit if the stock is expected to, and actually does appreciate. Any future appreciation is taxed at capital gains rates, and if held for more than one year after the Section 83(b) election is made, would receive LTCGs treatment rather than ordinary income tax treatment.

A Section 83(b) election must be filed with the IRS and is generally irrevocable. In addition, a significant consideration is that if the property is forfeited in the future because vesting requirements aren't met, the founder or employee may not take a loss for taxes already paid.

For an award of restricted stock, a Section 83(b) election is straightforward. The employee makes an election to be treated as if he or she received the stock immediately without vesting restrictions. As such, the employee would have ordinary income equal to the number of shares times the current FMV of the stock (the 409A valuation obtained by the company in the case of a closely held company).

For a stock option grant, the ability to make a Section 83(b) election will depend on whether the stock option grant agreement allows employees to make an early exercise. If the plan permits early exercise and at the time of exercise the FMV is low and the strike price is close or equal to the FMV, the spread will be small, thereby minimizing current income tax on NSOs and AMT on ISOs.

**IRC Section 83(i) election.** The Tax Cuts and Jobs Act, passed at the end of 2017, includes a new provision giving employees of pre-IPO companies additional flexibility. It is intended to benefit employees who vest in employer stock, whether through the settlement of an RSU or the exercise of an option before the company is traded on a public exchange. This is intended to help employees who have taxable income due to receiving vested stock, but lack the funds to pay the resulting tax.

The Tax Cuts and Jobs Act, passed at the end of 2017, includes a new provision giving employees of pre-IPO companies additional flexibility.

Section 83(i) mitigates this problem. It provides that an employee may elect to defer the income associated with vested stock. The employee must make the election within 30 days of vesting or exercise, in a manner similar to an 83(b) election.

Some founders and employees may be interested in transferring equity compensation to charity prior to a liquidity event. While the intent is noble, it's not always possible.

The ability to make an 83(i) election is limited to "qualified employees," which often will exclude founders. A qualified employee is one who does not meet any of the follow criteria:

– More than 1% owner of the company in the current or 10 preceding calendar years.
– The current or former CEO or CFO.
– A spouse, child, grandchild or parent of the first two categories.
– One of the four highest paid officers in the current or 10 preceding tax years.

Under an 83(i) election, income is deferred to the earliest tax year of the employee in which the following occurs:

– The stock becomes transferrable (including to the employer).
– The employee is no longer a qualified employee.
– The stock becomes readily tradable on an established securities market (i.e., an IPO).
– Five years after vesting of restricted stock or exercise of vested options.
– The employee affirmatively revokes the 83(i) election.

Note that the publicly traded trigger for taxation of income appears to ignore the lock-up period that typically prevents an employee from selling shares until six months after the IPO.

An 83(i) election is available only when the company grants stock options or restricted stock to at least 80% of the employees. For grants made after 2017, the rights and privileges of the restricted stock or options must also be the same for all employees. So a company may not make special grants to a few executives and still have those shares be eligible for deferral by the employee. An 83(i) election is not available if the employee already made an 83(b) election. And if an 83(i) election is made on ISOs, they will be treated as NQSOs going forward.

### Gifts to Charity

Some founders and employees may be interested in transferring equity compensation to charity prior to a liquidity event. While the intent is noble, it's not always possible. Equity compensation can be difficult to gift. Many times, there are restrictions put in place by the company that prohibit transfers. In addition, the Internal Revenue Service takes the position that the transfer of an unvested NSO isn't a completed gift for gift tax purposes.[1] Most tax professionals apply the same methodology to restricted stock and advise that unvested shares of restricted stock may not be gifted. The IRC specifically prohibits lifetime gifts of ISOs.[2] Therefore, only charitable gifts of vested restricted stock and vested NSOs may provide opportunities for gifting to charities.

Charitable gifts of vested restricted stock (not subject to company transfer restrictions) if held for more than one year after exercise or a Section 83(b) election should be considered an LTCGs asset and entitle the donor to an FMV deduction when contributed to a public charity, including a donor-advised fund (DAF). The deduction will be limited to 30% of the donor's adjusted gross income (AGI) in the year of the gift, with a five-year carryforward for any unused deduction. Because the business is closely held, a qualified appraisal will determine FMV, taking into consideration discounts for lack of marketability and lack of control. These discounts can range from 15% to 30%, which, depending on the extent of the discount, can basically wipe out the income tax benefit of contributing prior to a liquidity event. Qualified appraisals typically value NSOs based on something known as the "Black-Scholes Model." Gifts of closely held stock to private foundations (PFs) are treated less favorably. The deduction is typically limited to the donor's tax basis.

Charitable gifts of freely transferable vested NSOs typically aren't attractive. When the charity exercises the NSOs, the donor will recognize taxable income, and unless a Section 83(b) election has been made, the income will be taxable as ordinary income to the donor, and the donor's charitable deduction will be limited to tax basis, which is typically zero.[3]

### Gifts to Family

Like gifts to charity, only freely transferrable, vested restricted stock and NSOs are available for gifting to family. Restricted stock, assuming a low qualified appraisal, can be an excellent asset to gift to family. If the stock is expected to appreciate significantly, all future appreciations beyond the gift value won't be includible in the founder's estate. Valuation discounts for minority interests in the context of gifts to family can help reduce the gift's value significantly. Therefore, assuming a 35% discount were applied by a qualified appraiser, a gift of one dollar of restricted stock will only use 65 cents of gift tax value, thereby allowing the founder to leverage his or her $15,000 annual exclusion gifts and $11.18 million lifetime and generation skipping transfer tax exemptions applicable for 2018. Though beyond the scope of this article, the founder has an alphabet soup of irrevocable trusts that are available for gifting to family, including a grantor retained annuity trust, in which, if successful, future appreciation can be taken out of the founder's estate without using any lifetime exemption. Gifts to family of freely transferrable, vested NSOs can also be attractive, but the founder needs to understand that the income tax liability on the NSOs doesn't transfer to the beneficiary or to the trust for the benefit of the beneficiary. If the founder gifts NSOs, he or she will still be liable for the income taxes payable on the subsequent exercise of the NSOs. This may actually be an advantage because the tax payment reduces the founder's estate without incurring additional gift taxes.

Public stock received in an IPO or an acquisition is typically subject to a lock-up period of up to 180 days before the stock is permitted to be sold.

### After the Liquidity Event

**Restrictions on transfer, hedging or pledging public securities.** Just when the founder thinks he or she has seen the other end of a successful liquidity event and is ready to diversify his or her concentrated stock position, corporate lock-up agreements and certain securities law requirements say not so fast. Public stock received in an IPO or an acquisition is typically subject to a lock-up period (imposed by the underwriters in the case of an IPO and the acquiring public company in the case of an acquisition) of up to 180 days before the stock is permitted to be sold. In addition, most companies have restrictions on insider trading, hedging and pledging shares by executives. Founders may want to consider an SEC Rule 10b5-1 plan (a pre-established trading plan) to allow them to avoid violating corporate policies or securities laws. Finally, SEC Rule 144 provides a safe harbor from registration of certain securities so that an employee may sell securities in a public market place. The rules differ depending on whether the employee is considered a control person or a non-control person.

**Concentrated equity planning.** Assuming transfers, hedging and pledging of public stocks is permissible, there are a variety of concentrated stock strategies (in addition to outright sale) that can help with the risk of a concentrated stock position. The most common strategies are equity collars, prepaid variable forward contracts, charitable remainder trusts and exchange funds.

**Charitable planning.** Charitable planning after a liquidity event can be a tax-efficient way to be philanthropic while offsetting some of the taxes in the year of the liquidity event. Unlike pre-liquidity charitable planning, post-liquidity charitable planning is fairly straightforward. In the liquidity event, the founder received cash, public stock or a combination of cash and public stock. While cash gifts to a public charity are deductible up to 60% of AGI in the year of the gift (with a five-year carryforward), they're not as tax-efficient as gifting public stock (deductible up to 30% of AGI with a five-year carryforward). When gifting the stock to a public charity or PF (deductible at FMV for public stock), any income tax on the built-in capital gains on the stock disappears. All charitable vehicles are available post-sale, including outright gifts to public charities (including DAFs), gifts to PFs and gifts to charitable remainder and charitable lead trusts.

**Investment/financial planning.** Once the liquidity event has occurred, the founder working with a financial advisor should update the financial plan with the actual dollar amounts (taking into consideration taxes that may be owed on the liquidity event). Once the financial plan is updated, the founder will be able to determine which of the three buckets (discussed above) the net worth should be divided into. Again, the liquidity bucket contains the portion of the net worth necessary to maintain lifestyle. The second bucket is the longevity bucket and is made up of the assets needed to improve lifestyle. Any remaining assets go into the legacy bucket, which includes assets to help improve the lives of family and friends and to support philanthropic endeavors. Once the buckets are in place, the financial advisor can put together a proper investment strategy for each bucket. The financial plan should be updated annually to reflect markets, changes in circumstances and any necessity to move assets among the buckets.

Post-liquidity, there are some attractive income tax savings and deferral opportunities if the stock is considered qualified small business stock (QSBS).[4]

**Qualified small business stock.** Post-liquidity, there are some attractive income tax savings and deferral opportunities if the stock is considered qualified small business stock (QSBS).[4] QSBS is stock in a domestic C corp that operates an active business. To qualify, the corporation must use at least 80% of its asset value in the active conduct of one or more qualified trades or businesses (certain industries are excluded), and the gross assets of the corporation, as of the date the stock was originally issued, can't exceed $50 million.

On the sale of QSBS, the seller may exclude between 50% and 100% of the gain (depending on when acquired), up to the greater of: (1) $10 million, or (2) 10 times the basis in the QSBS. To qualify, the QSBS must be held for at least five years prior to the sale and the shareholders must have acquired the stock at its original issue, in exchange for money or property, or as compensation for services rendered.

In addition, on the sale of QSBS (held more than six months), the seller may elect to defer realized gain by reinvesting the sale proceeds into a new QSBS investment within 60 days of the sale.[5] The seller's basis in the replacement stock is reduced by the amount of the gain deferred. This ensures that gain continues to exist, but is merely deferred.

- *Erin Wilms,* Senior Wealth Strategist and Head of Advanced Planning
- *David Leibell,* Senior Wealth Strategist

The **Advanced Planning Group** of UBS provides comprehensive planning, advice, and education to ultra high net worth individuals and families. The team consists of professionals with advanced degrees, extensive planning experience, and various areas of expertise. Through our publications, the Advanced Planning Group features the intellectual capital of UBS in wealth planning, estate tax, and philanthropy and evaluates how changes in the legislative and tax landscape might impact our clients' planning.

See important notes and disclosures on the next page.

[1] Revenue Ruling 98-2.
[2] 26 U.S.C. Section 422(b) (5).
[3] Private Letter Rulings 9737014, 9737015, 9737016 (1997).
[4] 26 U.S.C. Section 1202.
[5] 26 U.S.C. Section 1045.

This report is provided for informational purposes only. The information is current as of the date indicated and is subject to change without notice.

Neither UBS Financial Services nor its employees (including its Financial Advisors) provide tax or legal advice. You should consult with your legal counsel and/or your accountant or tax professional regarding the legal or tax implications of a particular suggestion, strategy or investment, including any estate planning strategies, before you invest or implement.

**Important information about Advisory and Brokerage Services and financial planning services**
As a firm providing wealth management services to clients, UBS Financial Services Inc. offers both investment advisory and brokerage services. These services are separate and distinct, differ in material ways and are governed by different laws and separate contracts. It is important that clients understand the ways in which we conduct business and that they carefully read the agreements and disclosures that we provide to them about the products or services we offer. For more information on the distinctions between our brokerage and investment advisory services, please speak with your Financial Advisor or visit our website at **ubs.com/workingwithus**. In providing financial planning services, we may act as a broker-dealer or investment advisor, depending on whether we charge a fee for the service. Financial planning does not alter or modify in any way a client's existing account(s) or the terms and conditions of any account agreements they may have with UBS. 2018-38345_S

The information and data in the presentation may be deemed reliable; however, their accuracy and completeness are not guaranteed by UBS Financial Services Inc. and providing you with this information is not to be considered a solicitation on our part with respect to the purchase or sale of any securities, investments, strategies or products that may be mentioned. In addition, the information and data used are subject to change without notice.

Trust services are provided by UBS Trust Company, N.A. or another licensed trust company. UBS Trust Company, N.A. is an affiliate of UBS Financial Services, Inc. and a subsidiary of UBS AG. Trust investments are not deposits or other obligations of, or guaranteed by, UBS Trust Company, N.A. or UBS AG or any of their affiliates. Trust investments involve investment risks, including possible loss of the principal.