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THE HOLLOWAY GUIDE TO

Equity Compensation

Stock options, RSUs, job offers, and taxes—a detailed reference, including hundreds of resources, explained from the ground up, for both employees and managers.

ABOUT THIS BOOK ►

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Introduction

9 minutes, 5 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE
What are the best equity compensation resources for startups?
What is a good reference for job hunters on stock options?
What should everyone know about equity compensation when joining a startup?
Show 8 more

Equity compensation is the practice of granting partial ownership in a company in exchange for work. In its ideal form, equity compensation aligns the interests of individual employees with the goals of the company they work for, which can yield dramatic results in team building, innovation, and longevity of employment. Each of these contributes§ to the creation of value—for a company, for its users and customers, and for the individuals who work to make it a success.

The ways equity can be granted§ as compensation—including restricted stock, stock options, and restricted stock units—are **notoriously complex**. Equity compensation involves confounding terminology, legal obscurities, and many high-stakes decisions for those who give and receive it.

If you talk to enough employees and hiring managers, you'll hear stories of how they or their colleagues met with the painful consequences of not learning enough up front. Though many people learn the basic ideas from personal experience or from colleagues or helpful friends who have been through it before, the intricacies of equity compensation are best understood by tax attorneys, corporate lawyers, and other professionals.

Decisions related to negotiating an offer§ and exercising stock options§, in particular, can have **major financial consequences**. Because the value of employee equity is determined by the fate of the company, an employee's equity may be illiquid§ for a long time or ultimately worth nothing§, while taxes and the costs of exercise, if they apply, may not be recouped. Even when a company is doing well, an employee may suffer catastrophic tax pitfalls§ because they didn't anticipate the tax consequences of their decisions.

Understanding the technicalities of equity compensation does not guarantee that fortune will smile upon you as warmly as it did the early hires§ of Facebook. But a thorough overview can help you be informed when discussing with professionals§ for further assistance, make better decisions for your personal situation, and avoid some common§ and costly§ mistakes.

Why This Guide?

The first edition of this work, written by the same lead authors as the one you're reading now, received significant feedback and discussion on Hacker News, on GitHub, and from individual experts. Now, Holloway is pleased to publish this new edition of the Guide. We've expanded sections, added resources and visuals, and filled in gaps.

There is a lot of information§ about equity compensation spread across blogs and articles that focus on specific components of the topic, such as vesting, types of stock options, or equity levels. We believe there is a need for a consolidated and shared resource, written by and for people on different sides of compensation decisions, including employees, hiring managers, founders, and students. Anyone can feel overwhelmed by the complex details and high-stakes personal choices that this topic involves. This reference exists to answer the needs of beginners and the more experienced.

Holloway and our contributors are motivated by a single purpose: To help readers understand important details and their contexts well enough to make better decisions themselves. The Guide aims to be **practical** (with concrete suggestions and pitfalls to avoid), **thoughtful** (with context and multiple expert perspectives, including divergent opinion on controversial topics), and **concise** (it is dense but contains only notable details—still, it's at least a three-hour read, with links to three hundred sources!).

The Guide does not purport to be either perfect or complete. A reference like this is always in process. That's why we're currently testing features to enable the Holloway community to suggest improvements, contribute new sections, and call out anything that needs revision. We welcome (and will gladly credit) your help.

We especially wish to recognize§ the dozens of people who have helped write, review, edit, and improve it so far—and in the future—and hope you'll check back often as it improves.

Scope

COMMON QUESTIONS COVERED HERE
What aspects of equity compensation are covered by the Holloway Guide?
What aspects of equity compensation are not covered by the Holloway Guide?
What is the scope of the Holloway Guide to Equity Compensation?

This Guide **currently covers**:

- Equity compensation in **C corporations** in the **United States**.
- Equity compensation for most employees, advisors, and independent contractors in private companies, from startups through larger private corporations.
- Limited coverage of equity compensation in public companies.

Topics **not yet covered**:

- Equity compensation programs, such as ESPPs in public companies. (We'd like to see this improve in the future.)
- Full details on executive equity compensation.
- Compensation outside the United States.
- Compensation in companies other than C corporations, including LLCs and S corporations, where equity compensation is approached and practiced in very different ways.

For these situations, see other resources§ and get professional advice§.

Who May Find This Useful

COMMON QUESTIONS COVERED HERE
Who should read the Holloway Guide to Equity Compensation?

Is the Holloway Guide to Equity Compensation useful to me?
Is the Holloway Guide to Equity Compensation useful to experts?

Our aim is to be as helpful to the beginner as to those with more experience. Having talked with employees, CEOs, investors, and lawyers, we can assure you that no matter how much you know about equity compensation, you will likely run into confusion at some point.

If you're an **employee** or a **candidate for a job**, some of these may apply to you:

- You've heard phrases like *stock*, *stock options*, *strike price*, *ISOs*, *RSUs*, *83(b) election*, *409A valuation*, *AMT*, or *early exercise* and know they are probably important but are mystified by what some of them really mean or whether they apply to your situation.
- You're considering a job offer but don't know how to navigate or negotiate§ the equity component of the offer.
- You're joining a startup for the first time and are overwhelmed by all the paperwork§.
- You're quitting, taking a leave of absence, or are being laid off or fired from a company where you have stock or options and are thinking through the decisions and consequences.
- A company you work for is going through an acquisition, IPO, or shutdown.
- You have stock in a private company and need cash§.

Founders or **hiring managers** who need to talk about equity compensation with employees or potential hires will also find this Guide useful. As many entrepreneurs and hiring managers will tell you, this topic isn't easy on that side of the table, either! Negotiating with candidates and fielding questions from candidates and employees requires understanding the same complex technicalities of equity compensation well.

That said, this topic is **not simple** and we ask that readers be willing to invest time to get through a lot of confusing detail. If you're in a hurry, or you don't care to learn the details, this Guide may not be for you. Seek advice§.

A Note on Fairness

COMMON QUESTION COVERED HERE
How is the Holloway Guide to Equity Compensation useful to both hiring managers and employees?

Much of what you read about equity compensation was written by a single person, from a single vantage point. The authors and editors of this Guide have navigated the territory of equity compensation from the perspective of employees, hiring managers, founders, and lawyers. We do believe that the knowledge here, combined with professional advice§, can make a significant difference for **both employees and hiring managers**.

One of the difficulties for candidates negotiating equity compensation is that they may have less information about what they are worth than the person hiring them. Companies talk to many candidates and often have access to or pay for expensive market-rate compensation data. While some data on typical equity levels§ have been published online, much of it fails to represent the value of a candidate with their own specific experience in a specific role. However, even without exact data, candidates and hiring managers can develop better mental frameworks to think about offers and negotiations§.

On the other hand, challenges are not limited to those of employees. Founders and hiring managers also often struggle with talking through the web of technicalities with potential hires, and can make equally poor decisions when making offers. Either over-compensating or under-compensating employees can have unfortunate consequences.

In short, both companies and employees are routinely hurt by uninformed decisions and costly mistakes when it comes to equity compensation. A shared resource is helpful for both sides.

Roadmap

6 minutes, 2 links

GIVE THIS CHAPTER

The Holloway Reader

COMMON QUESTIONS COVERED HERE

What is the Holloway Reader?

What are some useful features of the Holloway Reader?

The Holloway Reader you're using now is designed to help you find and navigate the material you need. **Use the search box.** It will reveal definitions, section-by-section results, and content contained in **the hundreds of resources we've linked to** throughout the Guide. Think of it as a mini library of the best content on equity compensation. We also provide mouseover (or short tap on mobile) for **definitions of terms**, related section suggestions, and external links while you read.

How This Guide Is Organized

COMMON QUESTIONS COVERED HERE

How is the Holloway Guide to Equity Compensation organized?

What are the most important topics to understanding equity compensation?

This Guide contains a lot of material. And it's dense. Some readers may wish to read front to back, but you can also **search or navigate directly** to parts that are of interest to you, **referring back** to foundational topics as needed.

Equity compensation lies at the intersection of corporate law, taxation, and employee compensation, and so requires some basic understanding of all three. You might think compensation and taxation are separate topics, but they are so intertwined it would be misleading to explain one without the other. We cover material in logical order, so that if you do read the earlier sections first, later sections on the interactions of tax and compensation will be clearer.

We start with **Equity Compensation Basics**§: What compensation and equity are, and why equity is used as compensation.

But before we get much further, we need to talk about what stock is, and how companies are formed. **Fundamentals of Stock Corporations**§ covers how companies organize their ownership, how stock is issued, public companies and private companies, and IPOs and liquidity (which determine when equity is worth cash).

While not everyone reading this works at an early stage company, those who do can benefit from understanding the role of equity in **Startups and Growth**§. This is good context for anyone involved in a private company that has taken on venture capital.

How Equity is Granted§ is the core of this Guide. We describe the forms in which equity is most commonly granted, including restricted stock grants, stock options, and RSUs.

Now is where it gets messier—taxes:

- **Tax Basics**§: A technical summary of how taxation works. Many of the headaches of equity compensation involve how it is taxed, including ordinary income tax, long-term capital gains tax, and the lesser-known but sometimes critical alternative minimum tax.
- **Taxes on Equity Compensation**§: How much tax you owe is greatly affected by the kind of equity you have (such as restricted stock awards, stock options, or RSUs), when you choose to pay (including 83(b) elections), and when you choose to exercise options.

After these technical concerns, we move on to how you can think about all this in practice. These sections focus on scenarios common to employees and candidates, but are also of likely interest to founders and hiring managers:

- **Plans and Scenarios**§: Whether you have equity now or will in the future, it is helpful to learn *how to think about* the value of equity and its tax burden. We also cover whether you can sell private stock§.
- **Offers and Negotiations**§: Equity often comes up as you're negotiating or debating whether to accept a job offer. Here we cover what to expect, what to ask, tips and pitfalls, and more.

Finally, we offer some additional resources:

- **Documents and Agreements**§: A bit more detail on the actual legal paperwork you're likely to see as you negotiate and after you've accepted an offer.

- **Further Reading**§: A curated list of what else you can read on the subject, including many papers, books, and articles that have informed this Guide.

When to Turn Elsewhere

CEOs, **CFOs**, **COOs**, or anyone who runs a company or team of significant size should be sure to talk to an equity compensation consultant or a specialist at a law firm to learn about equity compensation plans.

Founders looking for an introduction to the legalities of running a company may wish to check out *Legal Concepts for Founders*, from Clerky, in addition to talking to a lawyer. Founders should also lean on their investors for advice, as they may have additional experience.

Executive compensation at large or public companies is an even more nuanced topic, on both sides of the table. Hire an experienced lawyer or compensation consultant. There are extensive legal resources available on executive compensation.

Seeking Professional Advice

COMMON QUESTIONS COVERED HERE
Should I seek professional advice before making decisions about equity compensation?
What kind of professional should I turn to for help with equity compensation?

This Guide does not replace professional advice.

Please read the full disclaimer§ and seek professional advice from a lawyer, tax professional, or other compensation expert before making significant decisions.

Does that make reading through these details a waste of time? Not at all. Important decisions rarely should or can be blindly delegated. This Guide *complements but does not replace* the advice you get from professionals. Working with the support of a professional can help you make better decisions when you have an understanding of the topic yourself and know what questions to ask.

Equity Compensation Basics

7 minutes, 25 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE
How does equity compensation work?
What are the fundamental concepts of equity compensation?
What is the history of equity compensation?
Show 10 more

History and Significance

COMMON QUESTIONS COVERED HERE

What is the history of equity compensation?
Why is equity such a significant component of executive compensation?
What percentage of employees hold stock options or shares in the company they work for?

Companies ranging from two-person startups to the Fortune 500 have found that granting partial ownership in a company is among the best methods to attract and retain exceptional talent. In the United States, partial ownership through stock options§ has been a key part of pay for executives and other employees since the 1950s.* As recently as 2014, **7.2%** of all private sector employees (**8.5 million** people) and **13.1%** of *all* employees of companies with stock held stock options, according to the National Center for Employee Ownership.* Many believe employee ownership has PAID fostered innovations in technology, especially in Silicon Valley, from the early days of Hewlett-Packard to recent examples like Facebook. Stock options helped the first 3,000 employees of Facebook enjoy roughly **$23 billion** at the time the company went public.*

CONTROVERSY Some controversy surrounds the use of equity compensation for high-paid executives. Public companies offer executives equity compensation in no small part because of a tax loophole. In 1993, President Bill Clinton attempted to limit executive pay with a new section* of the Internal Revenue Code. Unfortunately, the legislation backfired; a loophole made performance-based pay—including stock options—fully tax deductible, thereby creating a dramatic incentive to pay executives through stock options.* From 1970–79, the average compensation for a CEO of one of the 50 largest firms in the United States was **$1.2M**, of which **11.2%** was from stock options. By 2000–05, the same numbers had risen to **$9.2M** and **37%**, respectively.*

Growth and Risk

COMMON QUESTIONS COVERED HERE

What are the benefits of taking a pay cut to join a startup?
Is it risky to accept equity as compensation?

Generally, equity compensation is closely linked to the **growth** of a company. Cash-poor startups persuade early employees to take pay cuts and join their team by offering meaningful ownerships stakes§, catering to hopes that the company will one day grow large enough to go public§ or be sold§ for an ample sum. More mature but still fast-growing companies find offering compensation linked to ownership is more attractive than high cash compensation to many candidates.

With the hope for growth, however, also comes **risk**. Large, fast-growing companies often hit hard times. And startups§ routinely fail or yield no returns for investors or workers. According to a report by Cambridge Associates and Fortune Magazine, between 1990 and 2010, **about 60%** of venture capital-backed companies returned less than the original investment, leaving employees with the painful realization that their startup was not, in fact, the next Google. Of the remaining **40%**, just a select few go on to make many of their employees wealthy, as has been the case with iconic high-growth companies, like Starbucks,* UPS,* Amazon,* Google,* or Facebook.*

Compensation and Equity

COMMON QUESTIONS COVERED HERE

What is a good overview of compensation at startups?
What are the basics of equity compensation at stock corporations?
What does the term equity compensation mean?

DEFINITION

Compensation is any remuneration to a person (including employees, contractors, advisors, founders, and board members) for services performed or rendered to a company. Compensation comes in the forms of cash pay (salary and any bonuses) and any non-cash pay, including benefits like health insurance, family-related protections, perks, and retirement plans.

Company strategies for compensation are far from simple. Beth Scheer, head of talent at the venture fund Homebrew, offers a thoughtful overview of compensation in startups.

Another term you may encounter is *total rewards*, which refers to a model of attracting and retaining employees using a combination of salary and incentive compensation (like equity), benefits, recognition for contribution or commitment (like awards and bonuses), training programs, and initiatives to improve the work environment.

DEFINITION

In the context of compensation and investment, **equity** broadly refers to any kind of ownership in a company that can be held by individuals (like employees or board members) and by other businesses (like venture capital firms). One common kind of equity is stock, but equity can take other forms, such as stock options or warrants, that give ownership rights. Commonly, equity also comes with certain conditions, such as vesting or repurchase rights. Note the term *equity* also has several other technical meanings in accounting and real estate.

DEFINITION

Equity compensation is the practice of granting equity in exchange for work.

In this Guide we focus on equity compensation in stock corporations, the kind of company where ownership is represented by stock. (We describe stock in more detail in the next section§.) Equity compensation in the form of a direct grant of stock with no strings attached is very rare. Instead, employees are given stock with additional restrictions placed on it, or are given contractual rights that later can lead to owning stock. These forms of equity compensation include restricted stock, stock options, and restricted stock units, each of which we'll describe in detail§.

The Goals of Equity Compensation

COMMON QUESTIONS COVERED HERE

What are the goals of equity compensation?
Why do some companies use equity as a form of compensation?
What are the benefits of paying employees with equity?

The purpose of equity compensation is threefold:

- **Attract and retain talent.** When a company already has or can be predicted to have significant financial success, talented people are incentivized to work for the company by the prospect of their equity being worth a lot of money in the future. The actual probability of life-changing lucre may be low (or at least, lower than you may think if your entire knowledge of startups is watching "*The Social Network*"). But even a small chance at winning big can be worth the risk to many people, and to some the risk itself can be exciting.
- **Align incentives.** Even companies that can afford to pay lots of cash may prefer to give employees equity, so that employees work to increase the *future* value of the company. In this way, equity aligns individuals' incentives with the interests of the company. At its best, this philosophy fosters an environment of teamwork and a "rising tides lift all boats" mentality. It also encourages everyone involved to think long-term, which is key for company success. As we'll discuss later§, the amount of equity you're offered usually reflects both your contribution to the company and your commitment to the company in the future.
- **Reduce cash spending.** By giving equity, a company can often pay less in cash compensation to employees now, with the hope of rewarding them later, and put that money toward other investments or operating expenses. This can be essential in the early stages of a company or at other times where there may not be enough revenue to pay large salaries. Equity compensation can also help recruit senior employees or executives who would otherwise command especially high salaries.

Fundamentals of Stock Corporations

13 minutes, 35 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

How are stock and shares used by companies?

What do I need to know about stock corporations to understand equity compensation?

What is equity?

Show 16 more

In this section, we describe the basics of how stock and shares are used.

Those familiar with stock, stock corporations, public companies, and private companies can jump ahead§ to how those companies grant equity.

Kinds of Companies

COMMON QUESTIONS COVERED HERE

What kinds of companies use equity as a form of compensation?

Why are most startups C corporations?

DEFINITION

What is the difference between companies and corporations?

A **company** is a legal entity formed under corporate law for the purpose of conducting trade. In the United States, specific rules and regulations govern several kinds of business entities. Federal and state law have significant implications on liability and taxation for each kind of company. Notable types of companies include sole proprietorships, partnerships, limited liability companies (LLCs), S corporations, and C corporations.

DEFINITION

A **corporation** is a company that is legally recognized as an entity separate from its owners. The corporation itself, and not its owners, is obligated to repay debts and accountable under contracts and legal actions (that is, is a "legal person"). Most commonly, the term *corporation* is used to refer to a **stock corporation (or joint-stock company)**, which is a corporation where ownership is managed using stock. **Non-stock corporations** that do not issue stock exist as well, the most common being nonprofit organizations. (A few less common for-profit non-stock corporations also exist.)

In practice, people often use the word *company* to mean *corporation*.

DEFINITION

Incorporation is the legal process of forming (or **incorporating**) a new corporation, such as a business or nonprofit. Corporations can be created in any country. In the United States, incorporation is handled by state law, and involves filing articles of incorporation and a variety of other required information with the Secretary of State. (Note that the formation of companies that are not corporations, such as partnerships or LLCs, is not the same as incorporation.)

DEFINITION

A **C corporation (or C corp)** is a type of stock corporation in the United States with certain federal tax treatment. It is the most prevalent kind of corporation.* Most large, well-known American companies are C corporations. C corporations differ from S corporations and other business entities in several ways, including how income is taxed and who may own stock. C corporations have no limit on the number of shareholders allowed to own part of the company. They also allow other corporations, as well as partnerships, trusts, and other businesses, to own stock.

C corps are overwhelmingly popular for early-stage private companies[§] looking to sell part of their business in exchange for investment from individuals and organizations like venture capital firms (which are often partnerships), and for established public companies selling large numbers of stock to individuals and other companies on the public exchange.

In practice, for a few reasons, these companies are usually formed in Delaware, so legalities of all this are defined in Delaware law.** You can think of Delaware law as the primary "language" of U.S. corporate law. Incorporating a company in Delaware has evolved into a national standard for high-growth companies, regardless of where they are physically located.

CAUTION This Guide focuses specifically on C corporations and does not cover[§] how equity compensation works in LLCs, S corporations, partnerships, or sole proprietorships. Both equity and compensation are handled in significantly different ways in each of these kinds of businesses.

Loosely, one way to think about companies is that they are simply a set of contracts, negotiated over time between the people who own and operate the company, and which are enforced by the government, that aligns the interests of everyone involved in creating things customers are willing to pay for. Key to these contracts is a way to precisely track ownership of the company; issuing stock is how companies often choose to do this.

Stock and Shares

> COMMON QUESTIONS COVERED HERE
> *How is percentage ownership calculated?*
> *What is the difference between stock and shares?*
> *Do I need a stock certificate as proof of my ownership?*

DEFINITION

Stock is a legal invention that represents ownership in a company. **Shares** are portions of stock that allow a company to grant ownership to a variety of people or other companies in flexible ways. Each **shareholder (or stockholder)**, as these owners are called, holds a specific number of shares. Founders, investors, employees, board members, contractors, advisors, and other companies, like law firms, can all be shareholders.

DEFINITION

Stock ownership is often formalized on **stock certificates**, which are fancy pieces of paper that prove who owns the stock.

Sometimes you have stock but don't have the physical certificate, as it may be held for you at a law office.

Some companies now manage their ownership through online services called *ownership management platforms*, such as Carta. If the company you work for uses an ownership management platform, you will be able to view your stock certificates and stock values online.

Younger companies may also choose to keep their stock *uncertificated*, which means your sole evidence of ownership is your contracts with the company, and your spot on the company's cap table, without having a separate certificate for it.

DEFINITION

Outstanding shares refer to the total number of shares held by all shareholders. This number starts at an essentially arbitrary value (such as 10 million) when the company is created, and thereafter will increase as new shares are added (issued) and granted to people in exchange for money or services.

Outstanding shares may increase or decrease for other reasons too, such as stock splits and share buybacks, which we won't get into here.

Later, we discuss several subtleties§ in how shares are counted.

DEFINITION

Any shareholder has a **percentage ownership** in the company, determined by dividing the number of shares they own by the number of outstanding shares. Although stock paperwork will always list numbers of shares, if share value is uncertain, percentage ownership is often a more meaningful number, particularly if you know or can estimate a likely valuation of the company. Even if the number of shares a person has is fixed, their percentage ownership will change over time as the outstanding shares change. Typically, this number is presented in percent or **basis points** (hundredths of a percent).

Public and Private Companies

COMMON QUESTIONS COVERED HERE

What is the difference between public and private companies?

What does it mean to be a public company?

Are most startups private companies or public companies?

DEFINITION

Public companies are corporations in which any member of the public can own stock. People can buy and sell the stock for cash on public stock exchanges. The value of a company's shares is the value displayed in the stock market reports, so shareholders know how much their stock is worth.

DEFINITION

Most smaller companies, including all startups, are **private companies** with owners who control how those companies operate. Unlike a public company, where anyone is able to buy and sell stock, owners of a private company control who is able to buy and sell stock. There may be few or no transactions, or they may not be publicly known.

Governance

COMMON QUESTIONS COVERED HERE

What is the purpose of a board of directors?

Do all corporations have a board of directors?

What is the difference between inside and outside directors on a company's board?

DEFINITION

A corporation has a **board of directors**, a group of people whose legal obligation is to oversee the company and ensure it serves the best interests of the shareholders. Public companies are legally obligated to have a board of directors, while private companies often elect to have one. The board typically consists of **inside directors**, such as the CEO, one or two founders, or executives employed by the company, and **outside directors**, who are not involved in the day-to-day workings of the company. These **board members** are elected individuals who have legal, corporate governance rights and duties when it comes to voting on key company decisions. A board member is said to have a **board seat** at the company.

Boards of directors range from 3 to 31 members, with an average size of 9; for private companies the typical board size is typically between 3 and 7 directors. * Boards are almost always an odd number in order to avoid tie votes. It's worth noting that the state of California requires public companies to have at least one woman on their boards.*

Key decisions of the board are made formally in *board meetings* or in writing (called *written consent*).* Equity grants have to be by the board of directors.*

IPOs

COMMON QUESTIONS COVERED HERE
What does it mean for a company to "go public"?
On average, how long does it take for a private company to go from founding to IPO?

DEFINITION

A private company becomes a public company in a process called an **initial public offering (IPO)**. Historically, only private companies with a strong track record of years of growth have considered themselves ready to take this significant step. The IPO has pros and cons that include exchanging a host of high regulatory costs for the benefits of significant capital. After a company "IPOs" or "**goes public**," investors and the general public can buy stock, and existing shareholders can sell their stock far more easily than when the company was private.

Companies take years to IPO after being formed. The median time between a company's founding and its IPO has been increasing. According to a Harvard report, companies that went public in **2016** took **7.7 years** to do so, compared to **3.1 years** for companies that went public in **1996**.*

Sales and Liquidity

COMMON QUESTIONS COVERED HERE
What events can make a private company liquid?
What is the significance of liquidity to stock corporations?

⚠ DANGER With private companies, it can be very hard to know§ the value of equity. Because the value of private company stock is not determined by regular trades on public markets, shareholders can only make educated guesses about the likely future value, at a time when they will be able to sell stock.

After all, private company stock is simply a legal agreement that entitles you to something of highly uncertain value, and could well be worthless in the future, or highly valuable, depending on the fate of the company.

CONFUSION We'll discuss the notion of a company officially assigning a fair market value§ later, but even if a company gives you a value for your stock for tax and accounting purposes, it doesn't mean you can expect to sell it for that value!

DEFINITION

An **acquisition** is the purchase of more than 50% of the shares of one company (the acquired company) by another company (the purchaser). This is also called a **sale** of the acquired company. In an acquisition, the acquired company cedes control to the purchaser.

DEFINITION

The ability to buy and sell stock is called **liquidity**. In startups and many private companies, it is often hard to sell stock until the company is sold or goes public, so there is little or no liquidity for shareholders until those events occur. Thus, sales and IPOs are called both **exits** and **liquidity events**. Sales, dissolutions, and bankruptcy are all called **liquidations**.

Often people wish they could sell stock in a private company, because they would prefer having the cash. This is only possible occasionally. We get into the details later§, in our section on selling private stock.

DEFINITION

A **dividend** is a distribution of a company's profit to shareholders, authorized by the board of directors. Established public companies and some private companies pay dividends, but this is rare among startups and companies focused on rapid growth, since they often wish to re-invest their profits into expanding the business, rather than paying that money back to shareholders. Amazon, for example, has never paid dividends.

Startups and Growth

16 minutes, 43 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

How do startups raise money and grow?

What is the significance of rapid growth to startups?

What distinguishes startups from other small businesses?

Show 16 more

If you're considering working for a startup, what we cover next on how these early-stage companies raise money and grow is helpful in understanding what your equity may be worth.

If you're only concerned with large and established companies, you can skip ahead to how equity is granted§.

Startups

COMMON QUESTIONS COVERED HERE

What distinguishes startups from other small businesses?

What is the importance of growth in a startup?

What kind of companies are startups?

DEFINITION

A **startup** is an emerging company, typically a private company, that aspires to grow quickly in size, revenue, and influence. Once a company is established in the market and successful for a while, it usually stops being called a startup.

CONFUSION Unlike the terminology around corporations, which has legal significance, the term *startup* is informal, and not everyone uses it consistently.

Startups are not the same as small businesses. Small businesses, like a coffee shop or plumbing business, typically intend to grow slowly and organically, while relying much less on investment capital and equity compensation. Distinguished startup investor Paul Graham has emphasized that it's best to think of a startup as any early stage§ company intending to grow quickly.

∑ TECHNICAL C corporations dominate the startup ecosystem. LLCs tend to be better suited for slower-growth companies that intend to distribute profits instead of re-investing them for growth. Because of this, and for complex reasons related to how their capital is raised, venture capitalists significantly prefer to invest in C corporations.

Fundraising, Growth, and Dilution

Many large and successful companies began as startups. In general, startups rely on investors to help fund rapid growth.

DEFINITION

Fundraising is the process of seeking capital to build or scale a business. Selling shares in a business to investors is one form of fundraising, as are loans and initial coin offerings. **Financing** refers both to fundraising from outside sources and to bringing in revenue from selling a product or service.

DEFINITION

Venture capital is a form of financing for early-stage companies that individual investors or investment firms provide in exchange for partial ownership, or equity, in a company. These investors are called **venture capitalists (or VCs)**. Venture capitalists invest in companies they perceive to be capable of growing quickly and commanding significant market share. "Venture" refers to the risky nature of investing in early-stage businesses—typically startups—with unproven business models.

A startup goes through several stages of growth§ as it raises capital based on the hope and expectation that the company will grow and make more money in the future.

DEFINITION

Companies add (or "issue") shares during fundraising, which can be exchanged for cash from investors. As the number of outstanding shares goes up, the percentage ownership of each shareholder goes down. This is called **dilution**.

CONFUSION Dilution doesn't necessarily mean that you're losing anything as a shareholder. As a company issues stock and raises money, the smaller percentage of the company you *do* have could be worth more. The size of your slice gets relatively smaller, but, if the company is growing, the size of the cake gets bigger. For example, a typical startup might have three rounds of funding, with each round of funding issuing 20% more shares. At the end of the three rounds, there are more outstanding shares—roughly 73% more in this case, since 120%×120%×120% is 173%—and each shareholder owns proportionally less of the company.

DEFINITION

The **valuation** of the company is the present value investors believe the company has. If the company is doing well, growing revenue or showing indications of future revenue (like a growing number of users or traction in a promising market), the company's valuation will usually be on the rise. That is, the price for an investor to buy one share of the company would be increasing.

⚠ DANGER Of course, things do not always go well, and the valuation of a company does not always go up. It can happen that a company fails entirely and all ownership stakes become worthless, or that the valuation is lower than expected and certain kinds[§] of shares become worthless while other kinds have some value. When investors and leadership in a company expect the company to do better than it actually does, it can have a lot of disappointing consequences for shareholders.

Dilution Illustrations

COMMON QUESTIONS COVERED HERE
How is dilution best illustrated?
How does dilution work for existing shareholders when the startup raises another round of funding?
What happens to the value of my shares when more shares are issued?

These visualizations illustrate how ownership of a venture-backed company evolves as funding is raised. One scenario imagines changes to ownership in a well-performing startup, and the other is loosely based on a careful analysis of Zipcar,* a ride-sharing company that experienced substantial dilution before eventually going public and being acquired[§]. These diagrams simplify complexities such as the ones discussed in that analysis, but they give a sense of how ownership can be diluted.

Loading chart...

Stages of a Startup

COMMON QUESTIONS COVERED HERE
What are the typical growth stages of a startup?
What is the difference between companies and corporations?
What is the difference between Seed and Series A, B, and C funded startups?

Understanding the value of stock and equity in a startup requires a grasp of the stages of growth a startup goes through. These stages are largely reflected in how much funding has been raised—how much ownership, in the form of shares, has been sold for capital.

Very roughly, typical stages are:

- **Bootstrapped** (little funding or self-funded): Founders are figuring out what to build, or they're starting to build with their own time and resources.
- **Series Seed** (roughly $250K to $2 million in funding): Figuring out the product and market. The low end of this spectrum is now often called **pre-seed**.
- **Series A** ($2 to $15 million): Scaling the product and making the business model work.
- **Series B** (tens of millions): Scaling the business.
- **Series C, D, E, and beyond** (tens to hundreds of millions): Continued scaling of the business.

Keep in mind that these numbers are more typical for startups located in California. The amount raised at various stages is typically smaller for companies located outside of Silicon Valley, where what would be called a seed round may be called a Series A in, say, Houston, Denver, or Columbus, where there are fewer companies competing for investment from fewer venture firms, and costs associated with growth (including providing livable salaries) are lower. *** ***

CAUTION Most startups don't get far. According to an analysis of angel investments, by Susa Ventures general partner Leo Polovets, **more than half** of investments fail; **one in 3** are small successes (1X to 5X returns); **one in 8** are big successes (5X to 30X); and **one in 20** are huge successes (30X+). *****

CAUTION Each stage reflects the reduction of risk and increased dilution. For this reason, the amount of equity team members get is higher in the earlier stages (starting with founders) and increasingly lower as a company matures. (See the picture above.)

The Option Pool

COMMON QUESTIONS COVERED HERE
What is an option pool?
What percentage of stock typically makes up the option pool?
How do companies decide the size of the option pool?

DEFINITION

At some point early on, generally before the first employees are hired, a number of shares will be reserved for an employee **option pool (or employee pool)**. The option pool is part of a legal structure called an equity incentive plan. A typical size for the option pool is 20% of the stock of the company, but, especially for earlier stage companies, the option pool can be 10%, 15%, or other sizes.

Once the pool is established, the company's board of directors grants stock from the pool to employees as they join the company.

∑ TECHNICAL Well-advised companies will reserve in the option pool only what they expect to use over the next 12 months or so; otherwise, given how equity grants are usually promised, they may be over-granting equity. The whole pool may never be fully used, but companies should still try not to reserve more than they plan to use. The size of the pool is determined by complex factors between founders and investors. It's worth employees (and founders) understanding that a small pool can be a good thing in that it reflects the company preserving ownership in negotiations with investors. The size of the pool may be increased later.

Counting Shares

COMMON QUESTIONS COVERED HERE
How are outstanding shares counted?
What is the difference between authorized but unissued, issued and outstanding, and fully diluted shares?

There are some key subtleties you're likely to come across in the way outstanding shares§ are counted:

DEFINITION
Private companies always have what are referred to as **authorized but unissued** shares, referring to shares that are authorized in legal paperwork but have not actually been issued. Until they are issued, the unissued stock these shares represent doesn't mean anything to the company or to shareholders: no one owns it.

CONFUSION For example, a corporation might have 100 million *authorized* shares, but will only have *issued* 10 million shares. In this example, the corporation would have 90 million *authorized but unissued* shares. When you are trying to determine what percentage a number of shares represents, you do *not* make reference to the authorized but unissued shares.

CONFUSION You actually want to know the total issued shares, but even this number can be confusing, as it can be computed more than one way. Typically, people count shares in two ways: *issued and outstanding* and *fully diluted.*

DEFINITION
Issued and outstanding refers to the number of shares actually issued by a company to shareholders, and does not include shares that others may have an option to purchase.

DEFINITION

Fully diluted refers to all of the shares that a company has issued, all of the shares that have been set aside in a stock incentive plan, and all of the shares that could be issued if all convertible securities (such as outstanding warrants) were exercised.

A key difference between fully diluted shares and shares issued and outstanding is that the total of fully diluted shares will include all the shares in the employee option pool that are reserved but *not yet issued to* employees.

◇ IMPORTANT If you're trying to figure out the likely percentage a number of shares will be worth in the future, it's best to know the number of shares that are fully diluted.

∑ TECHNICAL Even the fully diluted number may not take into account outstanding convertible securities (like convertible notes) that are *waiting* to be converted into stock at a future milestone. For a more complete understanding, in addition to asking about the fully-diluted capitalization you can ask about any convertible securities outstanding that are not included in that number.

CONFUSION The terminology mentioned here isn't universally applied. It's worth discussing these terms with your company to be sure you're on the same page.

DEFINITION

A **capitalization table (cap table)** is a table (often a spreadsheet or other official record) that records the ownership stakes, including number and class of shares, of all shareholders in the company. It is updated as stock is granted to new shareholders. *

Classes of Stock

COMMON QUESTIONS COVERED HERE

What is the difference between common stock, preferred stock, and founder's stock?
What factors make liquidation preference complex?
What is the significance of liquidation overhang to my stock options?

DEFINITION

Investors often ask for rights to be paid back first in exchange for their investment. The way these different rights are handled is by creating different **classes of stock**. (These are also sometimes called **classes of shares**, though that term has another meaning in the context of mutual funds.)

DEFINITION

Two important classes of stock are **common stock** and **preferred stock**. In general, preferred stock has "rights, preferences, and privileges" that common stock does not have. Typically, investors get preferred stock, and founders and employees get common stock (or stock options).

The exact number of classes of stock and the differences between them can vary company to company, and, in a startup, these can vary at each round[§] of funding.

CONFUSION Another term you're likely to hear is *founders' stock*, which is (usually) common stock allocated at a company's formation, but otherwise doesn't have any different rights from other common stock.*

Although preferred stock rights are too complex to cover fully, we can give a few key details:

DEFINITION

Preferred stock usually has a **liquidation preference (or preference)**, meaning the preferred stock owners will be paid before the common stock owners when a liquidity event§ occurs, such as if the company is sold or goes public.

DEFINITION

A company is in **liquidation overhang** when the value of the company doesn't reach the dollar amount investors put into it. Because of liquidation preference, those holding preferred stock (investors) will have to be paid before those holding common stock (employees). If investors have put millions of dollars into a company and it's sold, employees' equity won't be worth anything if the company is in liquidation overhang and the sale doesn't exceed that amount.*

CONFUSION The complexities of the liquidation preference are infamous. It's worth understanding that investors and entrepreneurs negotiate a lot of the details around preferences, including:

- The *multiple*, a number designating how many times the investor must be paid back before common shareholders receive proceeds. (Often the multiple is 1X, but it can be 2X or higher.)
- Whether preferred stock is *participating*, meaning investors get their money back and also participate in proceeds from common stock.
- Whether there is a *cap*, which limits the payout if it is participating.
- ∑ TECHNICAL This primer by Charles Yu gives a concise overview. Founders and companies are affected significantly and in subtle ways by these considerations. For example, as lawyer José Ancer points out, common and preferred stockholders are typically quite different and their incentives sometimes diverge.
- The *Holloway Guide to Raising Venture Capital* explains liquidation preference overhang in detail.

IMPORTANT For the **purposes of an employee who holds common stock**, the most important thing to understand about preferences is that they're not likely to matter if a company does well in the long term. In that case, every stockholder has valuable stock they can eventually sell. But if a company fails or exits§ for less than investors had hoped, the preferred stockholders are generally first in line to be paid back. Depending on how favorable the terms are for the investor, if the company exits at a low or modest valuation, it's likely that common shareholders will receive little—or nothing at all.

How Equity Is Granted

25 minutes, 35 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

Are there different types of equity compensation?

What kinds of equity do companies grant employees?

What is the difference between stock options and stock grants?

Show 34 more

In this section we'll lay out how equity is granted in practice, including the differences, benefits, and drawbacks of common types of equity compensation, including restricted stock awards, stock options, and restricted stock units (RSUs). We'll go over a few less common types as well. While the intent[§] of each kind of equity grant is similar, they differ in many ways, particularly around how they are taxed[§].

Except in rare cases where it may be negotiable, the type of equity you get is up to the company you work for. In general, larger companies grant RSUs, and startups grant stock options, and occasionally executives and very early employees get restricted stock awards.

Restricted Stock Awards

COMMON QUESTIONS COVERED HERE

What are restricted stock awards?

What is restricted about restricted stock awards?

Do restricted stock awards have to vest?

Show 2 more

At face value, the most direct approach to equity compensation would be for the company to award stock to an employee in exchange for work. In practice, it turns out a company will only want to do this with restrictions on how and when the stock is fully owned.

Even so, this is actually one of the least common ways to get equity. We mention it first because it is the simplest form of equity compensation, useful for comparison as things get more complex.

DEFINITION

A **restricted stock award** is when a company grants someone stock as a form of compensation. The stock awarded has additional conditions on it, including a vesting schedule, so is called **restricted stock**. Restricted stock awards may also be called simply **stock awards** or **stock grants**.

∑ TECHNICAL What *restricted* means here is actually complex. It refers to the fact that the stock (i) has certain restrictions on it (like transfer restrictions) required for private company stock, and (ii) will be subject to repurchase at cost pursuant to a vesting schedule. The repurchase right lapses over the service-based vesting period, which is what is meant in this case by the stock "vesting."

CONFUSION Restricted stock awards are not the same thing as restricted stock units.

Typically, stock awards are limited to executives or very early hires, since once the value of the shares increases, the tax burden of receiving them (without paying the company for their value) can be too great for most people. Usually, instead of restricted stock, an employee will get stock options.

Stock Options

COMMON QUESTIONS COVERED HERE
What is the philosophy behind granting stock options?
How do stock options work?
What does it mean to exercise stock options?
Show 1 more

DEFINITION

Stock options are contracts that allow individuals to buy a specified number of shares in the company they work for at a fixed price. Stock options are the most common way early-stage companies grant equity.

DEFINITION

A person who has received a stock option grant is not a shareholder until they **exercise** their option, which means purchasing some or all of their shares at the strike price. Prior to exercising, an option holder does not have voting rights.

DEFINITION

The **strike price (or exercise price)** is the fixed price per share at which stock can be purchased, as set in a stock option agreement. The strike price is generally set lower (often much lower) than what people expect will be the *future* value of the stock, which means selling the stock down the road could be profitable.

CONFUSION *Stock options* is a confusing term. In investment, an *option* is a right (but not an obligation) to buy something at a certain price within a certain time frame. You'll often see stock options discussed in the context of investment. What investors in financial markets call *stock options* are indeed options on stock, but they are not *compensatory* stock options awarded for services. In this Guide, and most likely in any conversation you have with an employer, anyone who says "stock options" will be referring to compensatory stock options.

CONFUSION Stock options are not the same as stock; they are only the *right to buy stock* at a certain price and under a set of conditions specified in an employee's stock option agreement. We'll get into these conditions next.

TECHNICAL Although everyone typically refers to "stock options" in the plural, when you receive a stock option grant, you are receiving *an option* to purchase a given number of shares. So technically, it's incorrect to say someone "has 10,000 stock options."

It's best to understand the financial and tax implications§ before deciding when to exercise§ options. In order for the option to be tax-free to receive, the strike price must be the fair market value of the stock on the date the option is granted.

∑ TECHNICAL Those familiar with stock trading (or those with economics degrees) will tell you about the **Black-Scholes model**, a general mathematical model for determining the value of options. While theoretically sound, this does not have as much practical application in the context of employee stock options.

Vesting and Cliffs

COMMON QUESTIONS COVERED HERE

What is the standard vesting schedule for employee stock options at a startup?

What is a cliff in a vesting schedule?

How does vesting work?

Show 2 more

DEFINITION

Vesting is the process of gaining full legal rights to something. In the context of compensation, founders, executives, and employees typically gain rights to their grant of equity incrementally over time, subject to restrictions. People may refer to their shares or stock options vesting, or may say that a person is vesting or has fully vested.

DEFINITION

In the majority of cases, vesting occurs incrementally over time, according to a **vesting schedule**. A person vests only while they work for the company. If the person quits or is terminated immediately, they get no equity, and if they stay for years, they'll get most or all of it.

Awards of stock, stock options, and RSUs are almost always subject to a vesting schedule.

DEFINITION

Vesting schedules can have a **cliff** designating a length of time that a person must work before they vest at all.

For example, if your equity award had a one-year cliff and you only worked for the company for 11 months, you would not get anything, since you haven't vested in any part of your award. Similarly, if the company is sold within a year of your arrival, depending on what your paperwork says, you may receive nothing on the sale of the company.

A very common vesting schedule is vesting over **4 years**, with a **1 year** cliff. This means you get 0% vesting for the first 12 months, 25% vesting at the 12th month, and 1/48th (2.08%) more vesting each month until the 48th month. If you leave just before a year is up, you get nothing, but if you leave after 3 years, you get 75%.

DEFINITION

In some cases, vesting may be triggered by specific events outside of the vesting schedule, according to contractual terms called **accelerated vesting (or acceleration)**. Two kinds of accelerated vesting that are commonly negotiated are if the company is sold or undergoes a merger (**single trigger**) or if it's sold and the person is fired (**double trigger**).

CONTROVERSY Cliffs are an important topic. When they work well, cliffs are an effective and reasonably fair system to both employees and companies. But they can be abused and their complexity can lead to misunderstandings:

- The intention of a cliff is to make sure new hires are committed to staying with the company for a significant period of time. However, the flip side of vesting with cliffs is that if an employee is leaving—quits or is laid off or fired—just short of their cliff, they may walk away with no stock ownership at all, sometimes through no fault of their own, as in the event of a family emergency or illness. In situations where companies fire or lay off employees just before a cliff, it can easily lead to hard feelings and even lawsuits (especially if the company is doing well enough that the stock is worth a lot of money).* *
- IMPORTANT As a manager or founder, if an employee is performing poorly or may have to be laid off, it's both thoughtful and wise to let them know what's going on well before their cliff.
- TECHNICAL Founders often have vesting on their stock themselves. As entrepreneur Dan Shapiro explains, this is often for good reason.
- IMPORTANT As an employee, if you're leaving or considering leaving a company before your vesting cliff is met, consider waiting. Or, if your value to the company is high enough, you might negotiate to get some of your stock "vested up" early. Your manager may well agree that is is fair for someone who has added a lot of value to the company to own stock even if they leave earlier than expected, especially for something like a family emergency. These kinds of vesting accelerations are entirely discretionary, however, unless you negotiated for special acceleration in an employment agreement. Such special acceleration rights are typically reserved for executives who negotiate their employment offers heavily.
- Acceleration when a company is sold (called *change of control* terms) is common for founders and not so common for employees. It's worth understanding acceleration and triggers in case they show up in your option agreement, but these may not be something you can negotiate unless you are going to be in a key role.
- Companies may impose additional restrictions on stock that is vested. For example, your shares are very likely subject to a right of first refusal, which means that you can't sell the stock without offering it first to the company. And it can happen that companies reserve the right to repurchase vested shares in certain events.

How Options Expire

COMMON QUESTIONS COVERED HERE
How do stock options expire?
What is an exercise window?
If I quit my job, how long do I have to exercise my options?
Show 2 more

DEFINITION

The **exercise window (or exercise period)** is the period during which a person can buy shares at the strike price. Options are only exercisable for a fixed period of time, until they expire, typically seven to ten years as long as the person is working for the company. But this window is not always open.

⚠ DANGER **Expiration after termination.** Options can expire after you quit working for the company. Often, the expiration is **90 days** after termination of service, making the options effectively worthless if you cannot exercise before that point. As we'll get into later, you need to understand the costs, taxes[§], and tax liabilities[§] of exercise and to plan ahead. In fact, you can find out when you are granted the options, or better yet, before you sign an offer letter.

◇ IMPORTANT **Longer exercise windows.** Recently (since around 2015) a few companies are finding ways to keep the exercise window open for years after leaving a company, promoting this practice as fairer to employees. Companies with extended exercise windows include Amplitude,* Clef,* Coinbase,* Pinterest,* and Quora.* However, the 90-day exercise window remains the norm.

CONTROVERSY **The exercise window debate.** Whether to have extended exercise windows has been debated at significant length. Some believe extended exercise windows are the future, arguing that a shorter window makes a company's success a punishment to early employees.

Key considerations include:

- Everyone agrees that employees holding stock options with an expiring window often have to make a painful choice if they wish to leave: Pay for a substantial tax bill (perhaps five to seven figures) on top of the cost to exercise (possibly looking for secondary liquidity or a loan[§]) or walk away from the options.
- Many familiar with this situation have spoken out forcefully against shorter exercise windows, arguing that an employee can help grow the value of a company substantially—often having taken a lower salary in exchange for equity—but end up with no ownership because they're unable or unwilling to stay for the several years typically needed[§] before an IPO or sale.
- On the other side, a few companies and investors stand by the existing system, arguing that it is better to incentivize people not to leave a company, or that long windows effectively transfer wealth from employees who commit long-term to those who leave.
- Some focused on the legalities also argue that it's a legal requirement of ISOs to have a 90-day exercise window. While this is technically true, it's not the whole story. It is possible for companies to extend the exercise window by changing the nature of the options (converting them from ISOs to NSOs) and many companies now choose to do just that.
- Another path is to split the difference and give extended windows only to longer-term employees.
- Taken together, it's evident many employees have not been clear on the

nuances of this when joining companies, and some have LOGIN suffered because of it. With the risks of short exercise windows for employees becoming more widely known, longer exercise windows are gradually becoming more prevalent. As an employee or a founder, it is fairer and wiser to understand and negotiate these things up front, and avoid unfortunate surprises.

CONFUSION Options granted to advisors typically vest over a shorter period than employee grants, often one to two years, and may have have different exercise windows. The FAST templates§ give some typical guidelines about this.

Kinds of Stock Options

COMMON QUESTIONS COVERED HERE

What is the difference between statutory and non-statutory stock options?

What are the pros and cons of NSOs?

What are the pros and cons of ISOs?

Show 1 more

DEFINITION

Compensatory stock options come in two flavors, **incentive stock options (ISOs)** and **non-qualifying stock options (NQOs, or NQSOs)**. Confusingly, lawyers and the IRS use several names for these two kinds of stock options, including **statutory stock options** and **non-statutory stock options (or NSOs)**, respectively.

In this Guide, we refer to ISOs and NSOs.

TYPE	**ALSO CALLED**
Statutory	Incentive stock option, ISO
Non-statutory	Non-qualifying stock option, NQO, NQSO, NSO

- Companies generally decide to give ISOs or NSOs depending on the legal advice they get. It's rarely up to the employee which they will receive, so it's best to know about both. There are pros and cons of each from both the recipient's and the company's perspective.
- ISOs are common for employees because they have the possibility of being more favorable from a tax point of view than NSOs.
- CAUTION ISOs can only be granted to employees (not independent contractors or directors who are not also employees).
- But ISOs have a number of limitations and conditions and can also create difficult tax consequences§.

Early Exercise

COMMON QUESTIONS COVERED HERE

What does it mean to early exercise?
What happens to my unvested shares if I leave my company?
What are the advantages of early exercise?
Show 1 more

DEFINITION
Sometimes, to help reduce the tax burden on stock options, a company will make it possible for option holders to **early exercise (or forward exercise)** their options, which means they can exercise even before they vest. The option holder becomes a stockholder sooner, after which the vesting applies to actual stock rather than options. This will have tax implications[§].

CAUTION However, the company has the right to repurchase the *unvested* shares, at the price paid or at the fair market value of the shares (whichever is lower), if a person quits working for the company. The company will typically repurchase the unvested shares should the person leave the company before the stock they've purchased vests.

Restricted Stock Units

COMMON QUESTIONS COVERED HERE
How do RSUs work?
Are restricted stock units the same as restricted stock awards?
Do RSUs have to vest?
Show 1 more

While stock options are the most common form of equity compensation in smaller private companies, RSUs have become the most common type of equity award for public and large private companies. Facebook pioneered the use of RSUs as a private company to allow it to avoid having to register as a public company earlier.

DEFINITION
Restricted stock units (RSUs) refer to an agreement by a company to issue an employee shares of stock or the cash value of shares of stock on a future date. Each unit represents one share of stock or the cash value of one share of stock that the employee will receive in the future. (They're called *units* since they are neither stock nor stock options, but another thing altogether that is contractually linked to the value of stock.)

DEFINITION
The date on which an employee receives the shares or cash payment for RSUs is known as the **settlement date**.

- CAUTION RSUs may vest according to a vesting schedule. The settlement date may be the time-based vesting date or a later date based on, for instance, the date of a company's IPO.
- RSUs are difficult in a startup or early stage company because when the RSUs vest, the value of the shares might be significant, and taxes will be owed on the receipt of the shares.* This is not a bad result when the company has sufficient capital to help the employee make the tax payments, or the

company is a public company that has put in place a program for selling shares to pay the taxes. But for cash-strapped private startups, neither of these are possibilities. This is the reason most startups use stock options rather than RSUs or stock awards.

- RSUs are often considered less preferable to grantees since they remove control over when you owe tax. Options, if granted with an exercise price equal to the fair market value of the stock, are not taxed until exercise, an event under the control of the optionee. If an employee is awarded an RSU or restricted stock award which vests over time, they will be taxed on the vesting schedule; they have been put on "autopilot" with respect to the timing of the tax event. If the shares are worth a lot on the date of vesting, the tax burden can be significant.
- CONFUSION You don't want to confuse *restricted stock units* with *restricted stock*, which typically refers to restricted stock awards.

Using Promissory Notes to Buy Stock

Usually you need the cash to buy shares—maybe more than you can afford to pay at exercise time. Another, less common approach to be aware of is for companies to allow the person exercising options to avoid paying the cash up front and instead accept a promise of payment in the future.

DEFINITION

A company may accept a **promissory note** to exercise compensatory options. Essentially, a promissory note is like giving an "IOU" to the company instead of paying the company cash for shares. The note may either be a **recourse promissory note** or **non-recourse promissory note**. "Non-recourse" means the lender (the company) is prohibited from seeking a deficiency payment from the borrower (the recipient of the stock) personally if they do not pay; they only can foreclose on the property itself (in this case the stock).

∑ TECHNICAL The tax consequences to the company and the optionee depend on how the note is structured. If the note is non-recourse, for state law purposes the company will consider you an owner of the shares received in exchange for the non-recourse note, but the IRS will consider the shares still an option until the promissory note is paid (which would also affect timing for long-term capital gains).

∑ TECHNICAL Non-recourse promissory notes can also be used to extend option windows on stock options that are expiring (for example, after 10 years), while not requiring the holder of the options to pay until later, when the stock may be liquid or have higher value.

Of course, use of promissory notes is complex and entirely at the discretion of the company. Individuals considering the idea should discuss with a lawyer as well as the company.

Less Common Types of Equity

COMMON QUESTIONS COVERED HERE
What is phantom stock?
What are stock appreciation rights (SARs)?
Are warrants the same as stock options?

While most employee equity compensation takes the form of stock, stock options, or RSUs, a complete tour of equity compensation must mention a few less common forms.

DEFINITION

Phantom equity is a type of compensation award that references equity, but does not entitle the recipient to actual ownership in a company. These awards come under a variety of different monikers, but the key to understanding them is knowing that they are really just cash bonus plans, where the cash amounts are determined by reference to a company's stock. Phantom equity can have significant value, but may be perceived as less valuable by workers because of the contractual nature of the promises. Phantom equity plans can be set up as purely discretionary bonus plans, which is less attractive than owning a piece of something.

Two examples of phantom equity are phantom stock and stock appreciation rights:

DEFINITION

A **phantom stock** award is a type of phantom equity that entitles the recipient to a payment equal to the value of a share of the company's stock, upon the occurrence of certain events.

DEFINITION

Stock appreciation rights (SARs) are a type of phantom equity that gives the recipient the right to receive a payment calculated by reference to the appreciation in the equity of the company.

DEFINITION

Warrants are another kind of option to purchase stock, generally used in investment transactions. For example, in a convertible note offering, investors may also get a warrant, or a law firm may ask for one in exchange for what is in essence vendor financing. They differ from stock options in that they are generally shorter, stand-alone legal documents, not granted pursuant to an equity incentive plan. In contrast, such a "plan[§]" is intended to be used more broadly for employees, contractors, advisors, and board members.

Employees and advisors may not encounter warrants, but it's worth knowing they exist.

Tax Basics

11 minutes, 46 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

What are the fundamentals of income and employment tax?
What are the basic tax principles I need to know to understand income tax?
Can an understanding of tax basics help me navigate taxes on equity compensation?
Show 11 more

The awarding of equity compensation can give rise to multiple types of taxes for the recipient, including federal and state income taxes and employment taxes. Skip ahead§ to understand how taxes on equity work, but if you have time, this section gives a technical summary of tax fundamentals, just in case you (like most people!) never really figured out all the numbers on your pay stub.

Given the complexity, most taxpayers aren't aware of how their tax is calculated. It does take up thousands of pages* of the federal tax code and involves the intricate diversity of state tax law as well.*

You don't need to know every detail, and can rely on software and professionals to determine the tax you owe, but we do suggest understanding the different kinds of taxes, how large they can be, and how each is "triggered" by different events.

CONFUSION For those not already familiar with tax terminology, watch out: Many terms sound like regular English, but they're not. *Ordinary income, long-term* and *short-term, election, qualified small business,* and other phrases have very specific meanings we'll do our best to spell out.

Kinds of Income

COMMON QUESTIONS COVERED HERE
What is the difference between ordinary income and capital gains?
For tax purposes, what are the different types of income?
What do I need to do to qualify for long-term capital gains?
Show 1 more

DEFINITION
Income is the money an individual makes. For tax purposes, there are two main types of income, which are taxed differently. **Ordinary income** includes wages, salary, bonuses and interest made on investments. **Capital gains** are the profits an individual makes from selling assets, including stock.

One key difference between ordinary income and capital gains is that when capital gains taxes are calculated, consideration is given not just to the sale price of the asset but to the total gain or loss the investment incurred, each outcome having significantly different tax consequences.

DEFINITION
Capital gains are classified as long-term or short-term. **Long-term capital gains** are the profits an individual makes from selling assets, such as stock, a business, a house, or land, that were held for more than a year. **Short-term capital gains** are profits from the sale of assets held for less than a year.

Although this topic is not without PAID controversy, the general idea is, if you are selling something you've owned for a long time, you can be taxed at a lower rate.

All these rates have evolved over time based on economic and political factors, *
so you can be confident they will change again in the future.

NEW In 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), which made many changes to tax rates for the **2018** tax year. Long-term capital gains taxes did not change significantly.

Federal Taxes

COMMON QUESTIONS COVERED HERE

What are the kinds of federal income tax I may need to pay?

What is the alternative minimum tax?

Under federal tax law, what is considered ordinary income?

Show 2 more

DEFINITION

Income tax is the money paid by individuals to federal, state, and, in some cases, local governments, and includes taxation of ordinary income and capital gains. Generally, U.S. citizens, residents, and some foreigners must file and pay federal income tax.

IMPORTANT In general, federal tax applies to many kinds of income. If you're an employee at a startup, you need to consider four kinds of federal tax, each of which is computed differently.

CONFUSION When it comes to equity compensation, it's possible that you'll have to worry about *all of these*, depending on your situation. That's why we have a lot to cover here:

DEFINITION

Ordinary income tax is the tax on wages or salary income, and short-term investment income. The term **short-term capital gains tax** may be applied to taxes on assets sold less than a year from purchase, but profits from these sales are taxed as ordinary income. For a lot of people who make most of their money by working, ordinary income tax is the biggest chunk of tax they pay.

DEFINITION

Employment taxes are an additional kind of federal tax beyond ordinary income tax, and consist of Social Security and Medicare taxes that are withheld from a person's paycheck. Employment taxes are also referred to as **payroll taxes** as they often show up on employee pay stubs. The Social Security wage withholding rate in 2020 is 6.2% up to the FICA wage base of $137,700. The Medicare component is 1.45%, and it does not phase out above the FICA wage base.

DEFINITION

Long-term capital gains tax is a tax on the sale of assets held longer than a year. Long-term capital gains tax is often lower than ordinary income tax. Many investors hold assets for longer than a year in order to qualify for the lesser tax burden of long-term capital gains.

DEFINITION

Alternative minimum tax (AMT) is a supplemental income tax that applies to certain individuals in some situations. This type of tax does not come up for many taxpayers, but higher income earners and people in special situations may have to pay large AMT bills. AMT was first enacted in 1979 in response to reports that 155 wealthy individuals had paid no income tax in 1966.* It is not the same as ordinary income tax or employment tax, and is calculated according to its own rules.

⚠ DANGER AMT is relevant to you if you're reading this. It's important to understand because exercising ISOs can trigger AMT. In some cases a *lot* of AMT, *even when you haven't sold the stock* and have no money to pay. We discuss this later[§].

FIGURE: BRACKET RATES, INCOME, AND TAXES

Loading chart...

Loading chart...

Source: IRS and the Tax Foundation

A bit on how all this fits together:

- Ordinary income tax applies in the situations you're probably already familiar with, where you pay taxes on salaries or wages. Tax rates are based on filing status (if you are single, married, or support a family), and on which **income bracket** you fall under.

- **Income brackets.** For ordinary income, since the **2018** tax year, the income brackets are at **10%**, **12%**, **22%**, **24%**, **32%**, **35%**, and **37%** marginal tax rates—see Notice 1036 or a Tax Foundation summary for 2021. Be sure you understand how these brackets work, and what bracket you're likely to be in.

  - CONFUSION There is a popular misconception that if you move to a higher bracket, you'll make less money.* What actually happens is when you cross certain thresholds, each additional (marginal) dollar you make is taxed at a slightly higher rate, equal to the bracket you're in. After you earn more than your deduction, on which you pay no tax, your post-tax income looks like the diagram above. (More discussion on such misconceptions are in this Reddit thread.)

- Investment gains, such as buying and selling a stock, are similarly taxed at "ordinary" rates, unless they are **long-term**, which means you held the asset for more than a year.

- You also pay a number of other federal taxes (see a DOCUMENT summary for all states), notably:

  - **6.2%** for Social Security up to the FICA base wage (your first $137,700 in 2020)
  - **1.45%** for Medicare
  - **0.9%** Additional Medicare Tax on income over $200K (single) or $250K (married filing jointly)
  - **3.8%** Net Investment Income Tax (NII) (enacted as part of the Affordable Care Act,* also called "Obamacare") on investment income if you make over $200K (single) or $250K (married filing jointly).*

- Ordinary federal income tax, Social Security, and Medicare taxes are withheld from your paycheck by your employer and are called **employment taxes**.

- IMPORTANT Long-term capital gains are taxed at a lower rate than ordinary income tax: **0%**, **15%**, or **20%.*** This covers cases where you get dividends or sell stock after holding it a year. If you are in the middle brackets (more than about $40K and less than $445K of ordinary income for 2021), your long-term capital gains rate is 15%. You can find more detail on tax brackets at the Tax Foundation.

- AMT is a complex part of the federal tax code most taxpayers don't worry about. But it comes into play when exercising ISOs§. Most people do not pay AMT unless it is "triggered" by specific situations, typically high income (more than $500K) or high deductions. Whether you pay AMT also depends on the state in which you file, since your state taxes can significantly affect your deductions. If you are affected, AMT tax rates are usually at **26%** or **28%** marginal tax rate, but effectively **35%** for some ranges, meaning it is higher than ordinary income tax for some incomes and lower for others.* AMT rules are so complicated you often need professional tax help if they might apply to you. The IRS's AMT Assistant might also help.

- ◇ IMPORTANT Section 1202 of the Internal Revenue Code provides a special tax break for qualified small business stock held for more than five years. * Currently, this tax break is a 100% exclusion from income for up to $10M in gain. There are also special rules that enable you to rollover gain on qualified small business stock you have held for less than five years. Stock received on the exercise of options can qualify for the Section 1202 stock benefit.

State Taxes

COMMON QUESTIONS COVERED HERE
What state has the highest long-term capital gains tax rate?
What is the difference between ordinary income tax and long-term capital gains tax?
Can I move to another state to avoid California's long-term capital gains tax?

State tax rates and rules vary significantly. Since federal rates are much higher than state rates, you usually think of federal tax planning first. But you should also know a bit about tax rates in your state.

State long-term capital gains rates range widely. California has the highest, at **13.3%**; several states have none. *

◇ IMPORTANT For this reason, some people even consider moving to another state if they are likely to have a windfall gain, like selling a lot of stock after an IPO.

Taxes on Equity Compensation

19 minutes, 29 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE
What do I need to know about taxes and equity compensation?
What are the specific tax implications of stock options and awards?
What is a good overview of how equity compensation is taxed?
Show 30 more

Equity and taxes interact in complicated ways, and the tax consequences for an employee receiving restricted stock, stock options, or RSUs are dramatically different. This section will cover these messy details and help you make decisions that reduce the tax burden of your equity compensation.

83(b) Elections

This section covers one of the most important and complex decisions you may need to make regarding stock awards and stock options: paying taxes early with an 83(b) election.

- Generally, restricted stock is taxed as ordinary income *when it vests*.
- If the stock is in a startup with low value, this may not result in high tax. If it's been years since the stock was first granted and the company is now worth a lot, the taxes owed could be quite significant.

DEFINITION

The Internal Revenue Code, in Section 83(b), offers taxpayers receiving equity in exchange for work the option to pay taxes on their options before they vest. If qualified, a person can tell the IRS they prefer this alternative in a process called an **83(b) election**. Paying taxes early with an 83(b) election can potentially reduce taxes significantly. If the shares go up in value, the taxes owed at vesting might be far greater than the taxes owed at the time of receipt.

- CONFUSION Why is it called an *election*? Because you are *electing* (choosing) to pay taxes early in exchange for this treatment by the IRS. Does the IRS secretly enjoy making simple concepts sound confusing? We're not sure.
- An 83(b) election isn't guaranteed to reduce your taxes, however. For example, the value of the stock may not increase. And if you leave the company before you vest, you *don't* get back the taxes you've already paid.
- DANGER You must file the 83(b) election yourself with the IRS **within 30 days** of the grant or exercise, or the opportunity is irrevocably lost.
- CONFUSION Note an 83(b) election is made on receipt of actual shares of stock. Technically, it cannot be made on the receipt of a stock *option* itself: You first must exercise that option, then file the election.
- If you receive an early exercisable stock option (when you don't have to wait for the the stock to vest), you can make an 83(b) election upon receipt of the exercised shares.
- Section 83(b) elections do not apply to vested shares; the election only applies to stock that is not yet vested. Thus, if you receive options that are *not* early exercisable (meaning you have to wait until they vest to exercise), an 83(b) election would not apply.
- IMPORTANT Founders and very early employees will almost always want to do an 83(b) election upon the receipt of unvested shares, since the stock value is probably low. If the value is really low, and the taxes owed are not that great, you can make the election without having to pay much tax and start your capital gains holding period on the shares.

NEW With the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, Congress approved a **new Section 83(i)** that is intended to allow deferral of tax until RSU and stock option holders can sell shares to pay the tax bill. Whether companies will choose or be able to make this available to employees is not clear yet.

409A Valuations

COMMON QUESTIONS COVERED HERE

What is a 409A valuation?

What is the difference between a company's 409A valuation and its fair market value?

How often is a 409A valuation needed and how long is it good for?

Show 1 more

When a person's stock vests, or they exercise an option, the IRS determines the tax that person owes. But if no one is buying and selling stock, as is the case in most startups, then the value of the stock—and thus any tax owed on it—is not obvious.

DEFINITION

The **fair market value (FMV)** of any good or property refers to a price upon which the buyer and seller have agreed, when both parties are willing, knowledgeable, and not under direct pressure to carry out the exchange. The fair market value of a company's stock refers to the price at which a company will issue stock to its employees, and is used by the IRS to calculate how much tax an employee owes on any equity compensation they receive. The FMV of a company's stock is determined by the company's most recent 409A valuation.

DEFINITION

A **409A valuation** is an assessment private companies are required by the IRS to conduct regarding the value of any equity the company issues or offers to employees. A company wants the 409A to be low, so that employees make more off options, but not so low the IRS won't consider it reasonable. In order to minimize the risk that a 409A valuation is manipulated to the benefit of the company, companies hire independent firms to perform 409A valuations, typically annually or after events like fundraising.

The 409A valuation of employee equity is usually much less than what investors pay for preferred stock; often, it might be only a third or less of the preferred stock price.

CONTROVERSY Although the 409A process is required and completely standard for startups, the practice is a strange mix of formality and complete guesswork. It has been called "quite precise—remarkably inaccurate," by venture capitalist Bill Gurley. You can read more about its nuances and controversies.

A 409A does have to happen every 12 months to grant the company safe harbor. A 409A also has to be done after any event that could be deemed a "material event," which is a fancy way of saying any event that could change the price or value of the company meaningfully. Other examples could be if a CEO leaves, if the company starts making a ton of money, or if there is an acquisition.

- ∑ TECHNICAL "FMV" is a legal term defined in Supreme Court Case 546, United States vs. Cartwright.
- ∑ TECHNICAL "409A" is a reference to the section of the Internal Revenue Code that sets requirements for options to be tax-free on grant.

Taxes on ISOs and NSOs

COMMON QUESTIONS COVERED HERE

How are NSOs taxed?

How are ISOs taxed?

Are ISOs or NSOs more common in startups?

Show 1 more

Typically, early to mid-stage companies grant stock options, which may be ISOs or NSOs[§].

- DANGER When you get stock options and are considering if and when to exercise, you need to think about the taxes and **when you owe them**. In principle, you need to think about taxes you may incur at three points in time:
  - at **time of grant**
  - at **time of exercise**
  - at **time of sale**
- These events trigger ordinary tax (high), long-term capital gains (lower), or AMT (possibly high) taxes in different ways for NSOs and ISOs.

DEFINITION

The taxes at time of exercise will depend on the gain between the strike price and the FMV, known as the **spread** or the **bargain element**.

- IMPORTANT If you're granted ISOs or NSOs at a low strike price, and the bargain element is zero, then you may be able to exercise at a reasonable price without triggering taxes at all. So assuming the company allows it, it makes sense to early exercise *immediately* (buying most or all of the shares, even though they're not vested yet) and simultaneously file an 83(b) election.

- CAUTION An 83(b) election, as already discussed, is the choice to be taxed on the receipt of property even though you might have to forfeit or give back the property to the company. You can make an election on the receipt of stock, but you cannot make the election on the receipt of a stock option or an RSU because options and RSUs are not considered property for the purposes of Section 83(b).

- CAUTION ISOs are often preferred by startups, as they're supposedly better for employees from a tax perspective. This assumes that (1) AMT won't be triggered and (2) you'll get a low long-term capital gains rate by holding the stock for the appropriate holding periods. However, often you either run afoul of the AMT trap, or don't hold the stock long enough with the complicated 1 year + 2 year requirement, or the spread at exercise is small or zero, so the difference wouldn't matter anyway. NSOs do have a slightly higher tax because of the need to pay employment taxes on NSOs and not ISOs.

- CONTROVERSY Overall, it's not clear the ISO is that much better for employees, so many people argue for NSOs instead.

- CONFUSION This is partly because ISOs can make it harder to meet the long-term capital gains holding period.* Many people expect early exercise, together with an 83(b) election, will help them hold the stock long enough to qualify for long-term capital gains. While this is true for NSOs, a murky part of the rules on ISOs states that even with an 83(b) election, the capital gains holding period does not begin until the shares actually vest. So if you want to immediately exercise an option and file a Section 83(b) election, and you might have liquidity soon, it's better—for those who can—to do so with NSOs.

The AMT Trap

COMMON QUESTIONS COVERED HERE

What are the AMT consequences of early exercise?

Does the AMT apply to NSOs?

How does the AMT work?

Show 2 more

When it comes to taxes and equity compensation, one scenario is so dangerous we give it its own section.

DANGER If you have received an ISO, exercising it may unexpectedly trigger a big AMT bill—even before you actually make any money on a sale! If there is a large spread between the strike price and the 409A valuation, you are potentially on the hook for an enormous tax bill, even if you can't sell the stock. This has pushed people into bankruptcy. It also caused Congress to grant a one-time forgiveness, the odds of which happening again are very low.

DEFINITION

The catastrophic scenario where exercising ISOs triggers a large AMT bill, with no ability to sell the stock to pay taxes, is sometimes called the **AMT trap**. This infamous problem has trapped many employees and bankrupted people during past dot-com busts. Now more people know about it, but it's still a significant obstacle to plan around.

NEW In 2017, Congress passed the Tax Cuts and Jobs Act (TCJA), which increases AMT exemptions and their phaseout thresholds. This means fewer people will be affected by AMT in 2018 and later than in prior years. *

Note that if your AMT applies to events prior to 2008, you're off the hook.

Understand this topic and talk to a professional if you exercise ISOs. The AMT trap does not apply to NSOs.

Stock Awards vs. ISOs vs. NSOs

COMMON QUESTIONS COVERED HERE

How are stock awards taxed compared to stock options?

Are taxes the same for stock options and stock awards when they vest?

Are taxes the same for stock options and stock awards when they're sold?

Show 1 more

Because the differences are so nuanced, what follows is a summary of the taxes on restricted stock awards, ISOs, and NSOs, from an employee's point of view.

- **Restricted stock awards.** Assuming vesting, you pay full taxes early with the 83(b) or at vesting:
  - At grant:
    - if 83(b) election filed, ordinary tax on FMV
    - none otherwise
  - At vesting:
    - none if 83(b) election filed
    - ordinary tax on FMV of vested portion otherwise
  - At sale:
    - long-term capital gains tax on gain if held for **1 year** past when taken into income
    - ordinary tax otherwise (including immediate sale)
- **NSOs.** You pay full taxes at exercise, and the sale is like any investment gain:
  - At grant and vesting:
    - no tax if granted at (or above) FMV
  - At exercise:
    - ordinary income tax on the amount by which the FMV of the shares received exceeds the exercise price
    - income and employment tax withholding on paycheck
  - At sale:
    - long-term capital gains tax on gain if held for **1 year** past exercise
    - short-term capital gains tax (ordinary income tax rates) otherwise (this includes immediate sale at exercise)
- **ISOs.** You might pay less tax at exercise, but it's complicated:
  - At grant and vesting:
    - no tax if granted at (or above) FMV
  - At exercise:
    - **AMT tax event** on the bargain element
    - no ordinary or capital gains tax
    - no income or employment tax withholding on paycheck
  - At sale:
    - long-term capital gains tax if held for **1 year** past exercise and **2 years** past grant date
    - short-term capital gains tax (ordinary income tax rates) otherwise (this includes immediate sale at exercise)

Mary Russell, a lawyer who specializes in equity compensation, recommends each form of equity be used at the appropriate time in private companies: restricted stock awards for the earliest stage of a startup, stock options with longer exercise windows for the early to mid stage, and RSUs for the later stages.*

If you relish tax complexity, you can learn more from:

- The Tax Topics coverage of ISOs and NSOs from the IRS
- Joe Wallin's posts on the Startup Law Blog, "Top 6 Reasons To Grant NQOs Over ISOs" and "Incentive Stock Options vs. Nonqualified Stock Options"
- Investopedia's post "Get the Most Out of Employee Stock Options"
- EquityZen's summary of the topic, "Understanding Equity Compensation And What It Means For Startup Employees"

Taxes on RSUs

COMMON QUESTIONS COVERED HERE
What are the tax implications of restricted stock units (RSUs) as compensation?
When am I required to pay taxes on my RSUs?
How are RSUs taxed?
Show 1 more

If you are awarded RSUs, each unit represents one share of stock that you will be given when the units vest.

- Here's the tax summary for RSUs:
  - At grant:
    - no tax
  - At vesting/delivery:
    - ordinary tax on current share value
  - At sale:
    - long-term capital gains tax on gain if held for **1 year** past vesting
    - short-term capital gains tax (ordinary income tax rates) otherwise (this includes immediate sale)
- CAUTION When you receive your shares, you are taxed on their value at that time.* If you are an employee, this means you may have to write a check to the company to cover your income and employment tax withholding. Often, for U.S. employees, companies will withhold the tax in the form of shares such that no action is required by the employee at vesting time.*
- If you receive an RSU when the stock is of little value, you cannot elect to be taxed on the value of that stock when you receive the RSU—you pay taxes at vesting time, based on the value of the shares at that time.
- CAUTION RSUs present some big problems in private companies:
  - You will owe tax when you receive the shares, even though they are illiquid.
  - You can't minimize the tax impact of an increase in value of the

underlying shares between the date you receive the RSU and the date it is settled.

  - If you are an employee you will have to write a check to the company to satisfy your income and employment tax withholding.

- CAUTION RSUs are less attractive than stock options from a tax point of view because you cannot make an 83(b) election with respect to RSUs. By contrast, if you receive a stock option, as long as it's priced at fair market value you will have no income upon receipt of the options, and your income tax and employment tax consequences will be deferred until you exercise, an event under your control for the most part.

Tax Comparison Table

COMMON QUESTIONS COVERED HERE
How are different types of equity compensation taxed?
How can I compare the ways equity compensation is taxed?
Are all types of equity compensation taxed the same?
Show 1 more

TABLE: COMPARING TAXES ON TYPES OF EQUITY COMPENSATION

This table is a summary of the differences in taxation on types of equity compensation.

	RESTRICTED STOCK AWARDS	**ISOS**	**NSOS**	**RSUS**
Tax at grant	If 83(b) election filed, ordinary tax on FMV. None otherwise.	No tax if granted at FMV.	No tax if granted at FMV.	No tax.
Tax at vesting	None if 83(b) election filed. Ordinary tax on FMV of vested portion otherwise.	No tax if granted at FMV.	No tax if granted at FMV.	Ordinary tax on current share value.
Tax at exercise		AMT tax event on the bargain element. No ordinary or capital gains or employment tax.	Ordinary tax on the bargain element. Income and employment tax.	
Tax at sale	Long-term capital gains tax on gain if held for **1 year** past when taken into income. Ordinary tax otherwise (including immediate sale).	Long-term capital gains if held for **1 year** past exercise and **2 years** past grant date. Ordinary tax otherwise (including immediate sale).	Long-term capital gains if held for **1 year** past exercise. Ordinary tax otherwise (including immediate sale).	Long-term capital gains tax on gain if held for **1 year** past vesting. Ordinary tax otherwise (including immediate sale).

Tax Dangers

COMMON QUESTIONS COVERED HERE
What are the most costly tax mistakes related to equity compensation?
How can I avoid real tax dangers with my ISOs?
What are the essential things to know to avoid huge tax bills on my equity compensation?

Show 1 more

Because they are so important, we list some costly errors to watch out for when it comes to taxes on equity compensation:

- ⚠ DANGER If you are going to file an 83(b) election, it must be **within 30 days** of stock grant or option exercise. Often, law firms will take a while to send you papers, so you might only have a week or two. If you miss this window, it could potentially have giant tax consequences, and is essentially an irrevocable mistake—it's one deadline the IRS won't extend. When you file, get documentation from the post office as well as a delivery confirmation, and include a self-addressed, stamped envelope for the IRS to send you a return receipt. (Some people are so concerned about this they even ask a friend to go with them to the post office as a witness!)
- ⚠ DANGER Watch out for the AMT trap we've already discussed.
- ⚠ DANGER If you exercise your options, and your income had been from consulting rather than employment (1099, not W-2), you will be subject to the self-employment tax, which consist of both the employer and the employee side of FICA. In addition to owing the normal income tax, this means you will owe the Social Security tax component (**6.2%**) up to the FICA wage base, and you will owe the Hospital Insurance component (**2.9%**) on all of your income.
- ⚠ DANGER Thoughtfully decide when to exercise options. As discussed, if you wait until the company is doing really well, or when you are leaving, the delay can have serious downsides.

Plans and Scenarios

12 minutes, 19 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE
What are some common scenarios faced by people weighing offers that include equity compensation?
What factors should I consider when deciding if I should accept an equity compensation package?
What do I need to know to evaluate my offer of equity compensation?
Show 7 more

Evaluating Equity Compensation

COMMON QUESTIONS COVERED HERE
What do I need to know to evaluate my offer of equity compensation?
What factors are most important when determining the value of an equity compensation package?

Once you understand the types of equity§ and their tax implications§, you have many of the tools you need to evaluate an offer that includes equity compensation, or to evaluate equity you currently have in a company.

In summary, you have to determine or make educated guesses about several things:

- **Equity value.** This can be estimated by the value the company may have in the future, and the number of shares you may own.
  - **Percentage ownership.** As we've mentioned, knowing how many shares of stock or stock options you have is meaningless unless you know the number of outstanding shares. What matters is the percentage ownership of the company the shares represent, including the details§ of how the total is counted.
  - **Risk.** It is critical to understand risk§ in the business and dilution to ascertain the possible future value of equity. This article from Leo Polovets provides some additional thoughts.
- **Vesting.** Understand when§ you will receive the equity, as well as whether you're able to exercise stock options (and pay the associated costs and taxes), and whether you can do all this before your exercise window expires.
- **Liquidity.** Determine when you will be able to sell your shares§, and if that is likely to be for a profit at that time. (We talk about liquidity of private stock next.)
- **Tax.** Tax concerns§ are inseparable from the value of equity. Know the tax implications of your possible grant, exercise, vesting, and sale, in terms of ordinary income tax, employment tax, long-term capital gains, and alternative minimum tax.

That's a lot, and even so, decisions are uncertain, but it is possible to make much more informed decisions once you have this information.

What Is Private Stock Worth?

We now turn to the question of determining the value of private company stock. We've seen how stock in private companies often can't be sold§, so its value is difficult to estimate.

The value of equity you cannot yet sell is a reflection of three major concerns:

1. How well the company is doing now—that is, how profitable it is, or how many customers it is attracting.
2. How well the company will perform in the future.
3. How likely it is the company will be valuable as part of another company—that is, whether it may be acquired§.

The first concern is relatively clear, if you know the company's financials. The second and third come down to predictions and are never certain. In fact, it's important to understand just how uncertain all three of these estimations are, depending on the stage of the company.

In earlier stage private companies, there may be little or no profit, but the company may seem valuable because of high expectations that it can make future profit or be acquired. If a company like this takes money from investors, the investors determine the price they pay based on these educated guesses and market conditions.

In startups there tends to be a high degree of uncertainty about the future value of equity, while in later stage private companies financials are better understood (at least to investors and others with an inside view of the company), and these predictions are often more certain.

Can You Sell Private Stock?

Ultimately, the value of your equity depends on whether and when you are able to convert it into stock that you sell for cash. With public companies, the answer is relatively easy to estimate—as long as there are no restrictions on your ability to sell, you know the current market value of the stock you own or might own. What about private companies?

A liquidity event is usually what makes it possible for shareholders in a private company to sell their stock. However, individuals may sometimes be able to gain liquidity while a company is still private.

DEFINITION

A **secondary market (or secondary sale, or private sale)** transaction is when private company stock is sold to another private party. This is in contrast to **primary market** transactions, where companies sell directly to investors. Secondary sales are not routine, but they can sometimes occur, such as when an employee sells to an accredited investor who wants to invest in the company.

DEFINITION

Shares held by an employee are typically subject to a **right of first refusal (ROFR)** in favor of the company, meaning the employee can't sell their shares to a third party without offering to sell their shares to the company first.

CAUTION Private sales generally require the agreement and cooperation of the company, for both contractual and practical reasons. While those who hold private stock may hope or expect they need only find a willing buyer, in practice secondary sales only work out in a few situations.

Unlike a transaction on a public exchange, the buyer and seller of private company stock are not in total control of the sale. There are a few reasons **why companies may not support secondary sales**:

- Historically, startups have seen little purpose in letting current employees sell their stock, since they prefer employees hold their stock and work to make it more valuable by improving the value of the company as a whole.
- Even if employee retention is not a concern, there are reasons private sales may not be in the company's interest. Former employees and other shareholders often have difficulty initiating secondary transactions with a

company.* Private buyers may ask for the company's internal financials in order to estimate the current and future value of its stock; the company may not wish to share this confidential information.

- Companies must consider whether sales could influence their 409A valuation§.
- Secondary sales are an administrative and legal burden that may not make it to the top of the list of priorities for busy startup CEOs and CFOs.

◇ IMPORTANT However, participation in the secondary market has evolved in recent years,* * * and **a few options may be possible**:

- Forge and EquityZen have sought to establish a market around secondary sales, particularly for well-known pre-IPO companies.
- A few other secondary firms have emerged that have interest in certain purchases, especially for larger secondary sales from founders, early employees, or executives. A company can work with a firm to facilitate multiple transactions. These firms include 137 Ventures, ESO Fund, Akkadian Ventures, Industry Ventures, Atlas Peak, and Founders Circle.
- In some cases, an employee may have luck selling stock privately to an individual, like a board member or former executive, who wishes to increase their ownership. Further discussion can be found on Quora.

Stock Option Scenarios

COMMON QUESTIONS COVERED HERE
How should I decide when to exercise my options?
How does a cashless exercise work?
What is the benefit of waiting until acquisition to exercise?

The key decisions around stock options are when to exercise and, if you can, when to sell. Here we lay out some common scenarios that might apply to you. Considering these scenarios and their outcomes can help you evaluate your position and decide what you should do.

- **Exercise and hold.** You can write the company a check and pay any taxes on the spread. You are then a stockholder, with a stock certificate that may have value in the future. As discussed§, you may exercise:
  - Early, even immediately upon grant.
  - Before vesting (if early exercise is available to you).
  - Sometime after vesting.
  - After leaving the company, as long as the exercise window is open.
    - ⚠ CAUTION Recall that the window is likely to close soon§ after you leave a company, often 90 days after termination.
- **Wait until acquisition.** If the company is acquired for a large multiple of the exercise price, you may then use your options to buy valuable stock. However, as discussed, your shares could be worth next to nothing unless the

sale price exceeds the liquidation overhang.

- CAUTION **Secondary market.** As discussed§, in some cases it's possible to exercise and sell the stock in a private company directly to a private party. But this generally requires some cooperation from the company and is not something you can always count on.

- **Cashless exercise.** In the event of an IPO, a broker can allow you to exercise all of your vested options and immediately sell a portion of them into the public market, removing the need for cash up front to exercise and pay taxes.

IMPORTANT Note that some of these scenarios may require significant cash up front, so it makes sense to do the math early. If you are in a tight spot, where you may lose valuable options altogether because you don't have the cash to exercise, it's worth exploring each of the scenarios above, or combinations of them, such as exercising and then selling a portion to pay taxes. In addition, there are a few funds§ and individual investors who may be able to front you the cash to exercise or pay taxes in return for an agreement to share profits.

Author and programmer Alex MacCaw explores a few more detailed scenarios.

Summary of Dangers

COMMON QUESTIONS COVERED HERE

What risks and dangers associated with stock options do I need to be aware of?
What are the key dangers for an employee when it comes to equity compensation?
What are some disadvantages of equity compensation, including stock options?

Because of their importance, we'll wind up with a recap of some of the key dangers we've discussed when thinking about equity compensation:

- DANGER When it comes to equity compensation, details matter! You need to understand the type of stock grant or stock option in detail, as well as what it means for your taxes, to know what your equity is worth.

- DANGER Because details are so important, professional advice§ from a tax advisor or lawyer familiar with equity compensation (or both) is often a good idea. Avoid doing everything yourself, but also avoid blindly trusting advisors without having them explain the details to you in a way you understand.

- DANGER With stock options, high exercise costs or high taxes, including the AMT trap, may prevent you from exercising your options. If you can't sell the stock and your exercise window is limited, you could effectively be forced to walk away from your stock options.

- DANGER If a job offer includes equity, you need a lot of information to understand the value of the equity component. If the company trusts you enough to be making an offer but doesn't want to answer questions about that offer, consider it a warning sign.

Next, we offer more details on what to ask about your offer, and how to negotiate to get the answers you want.

Offers and Negotiations

29 minutes, 56 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

Where can I find tips and advice for negotiating a job offer that includes equity compensation?

What is a good resource for navigating the complexities of negotiation in startup job offers?

Why is negotiating a job offer important?

Show 25 more

When a company offers any form of equity as part of its compensation package, there is a whole new set of factors for a prospective employee to consider. This chapter will help you prepare for negotiating a job offer that includes equity, covering negotiation tips and expectations, and specific reminders on what you can ask and what is negotiable when it comes to equity.

Why Negotiation Matters

COMMON QUESTIONS COVERED HERE

Why is negotiating a job offer important?

Am I expected to negotiate the startup job offer I received?

What are the pros and cons of negotiating a job offer?

Before accepting any job offer, you'll want to negotiate firmly and fairly. You're planning to devote a lot of your time and sanity to any full-time role; help yourself make sure that this is PAID what you want.

CONFUSION It's perfectly natural to be anxious about negotiations, whether you're going through this process for the first time or the tenth. There is a lot at stake, and it can be uncomfortable and stressful to ask for things you need or want. Many people think negotiating could get the job offer revoked, so they'll accept their offer with little or no discussion. But remember that negotiations are the first experience you'll have of working with your new team. If you're nervous, it can help to remind yourself why it's important to have these conversations:

- Negotiations ask you to focus on what you actually want. What is important to you—personal growth, career growth, impact, recognition, cash, ownership, teamwork? Not being clear with yourself on what your priorities really are is a recipe for dissatisfaction later.
- If you aren't satisfied with the terms of your offer, accepting it without discussion can be tough not just for you but for your new company and colleagues as well. No one wants to take on a hire who's going to walk away in just a few months when something better comes along. For everyone's sake, take your time now to consider what you want—and then ask for it.
- The negotiation process itself can teach you a lot about a company and your future manager. Talking about a tough subject like an offer is a great way to see how you'll work with someone down the road.

A Guide like this can't give you personalized advice on what a reasonable offer is, as that depends greatly on your skills, the marketplace of candidates, what other offers you have, what the company can pay, what other candidates the company has found, and the company's needs. But we can cover the basics of what to expect with offers, and advise candidates on how to approach negotiations.

Equal Treatment

COMMON QUESTIONS COVERED HERE
Are all candidates given equal treatment in the hiring process?
As a hiring manager, what can I do to ensure candidates are treated equally?

◇ IMPORTANT Companies can and should work hard to ensure that all candidates are given equal treatment in the hiring process, but inequalities persist.* Workplace disparities in pay and opportunity span race and gender, * with research focusing on inequality in the U.S. workplace,* executive leadership and its well-documented lack of diversity,* * and the technology industry.* Gender bias in negotiation itself is also an issue; many women have been made to feel that they shouldn't ask for what they deserve.*

More effort is needed to end biases and close the wage gap. All candidates should take the time to understand their worth and the specific value they can add to a company, so that they are fully prepared to negotiate for a better offer.

General Expectations

COMMON QUESTIONS COVERED HERE
What are the general expectations around salary and equity in private company job offers?
Should I use a competing offer as leverage to improve my offer from another company?
For early stage startups, what expectations should candidates have about salary and equity?

- Many companies will give some leeway during negotiations§, letting you indicate whether you prefer higher salary or higher equity.
- Candidates with competing offers almost always have more leverage and get better offers.*
- Salaries at startups are often a bit below what you'd get at an established company, since early on, cash is at a premium. For very early stage startups, risk is higher, offers can be more highly variable, and variation among companies will be greater, particularly when it comes to equity.
- The dominant factors determining equity§ are what funding stage§ a company is at, and the role you'll play at the company. If no funding has been raised, large equity may be needed to get early team members to work for very little or for free. Once significant funding of an A round is in place, most people will take typical or moderately discounted salaries. Startups with seed funding lie somewhere in between.

Offers

COMMON QUESTIONS COVERED HERE
What are the usual components of an offer letter that includes equity compensation?
What details may be part of my total compensation but not be mentioned in my offer letter?
What details might my written offer letter include that were not in my verbal offer?

DEFINITION
When making a job offer, companies will often give a candidate a **verbal offer** first, to speed things along and facilitate the negotiation, following it with a **written offer** if it seems like the candidate and the company are close to agreement on the terms of the offer. The written offer takes the form of an DOCUMENT **offer letter**, which is just the summary sent to the candidate, typically with an expiration date and other details and paperwork§.

Although companies often want you to sign right away to save time and effort, if you're doing it thoughtfully you'll also be talking to the company (typically with a hiring manager, your future manager, or a recruiter, or some combination) multiple times before signing. This helps you negotiate details and gives you a chance to get to know the people you could be working with, the company, and the role, so that you can make the best decision for your personal situation.

When you are ready to accept the terms of the offer letter, you can go ahead and sign.

Things to look for in the offer letter include:

- **Title and level.** What your role is officially called, who you report to, and what level of seniority your role is within the company.
- **Salary.** What you're paid in cash, in a year, before taxes.
- **Equity compensation.** You know what this is now.
- **Bonus.** Additional cash you'll get on a regular basis, if the company has a plan for this.
- **Signing bonus.** Cash you get just for signing. (Signing bonuses usually have some strings attached—for example, you could have to pay back the bonus if you leave the company within 12 or 24 months.)

While the details may not be included in your offer letter, to get full information on your total rewards you'll also want to discuss:

- Benefits like health insurance, retirement savings, and snacks.
- All other aspects of the job that might matter to you, like time off, ability to work from home, flexible hours, training and education, and so on.

A few general notes on these components (credits to Cristina Cordova for some of these):

- Early stage startups will focus on salary and equity and (if they are funded) benefits. An offer of bonuses or a signing bonus are more common in larger, prosperous companies.

- Bonuses are usually standardized to the company and your level, so are not likely to be something you can negotiate.
- The signing bonus is highly negotiable. This doesn't mean any company will give large signing bonuses, but it's feasible because signing bonus amounts vary candidate by candidate, and unlike salary and other bonuses, it's a one-time cost to the company.

Offers From Startups

> COMMON QUESTIONS COVERED HERE
> *With offers from startups, what factors should I weigh to decide how much equity versus cash is right for me?*
> *How important is job title in an offer from an early stage startup?*
> *Does the stage a startup is at affect how much cash versus equity may be offered?*

Because startups are so much smaller than many established companies, and because they may grow quickly, there are additional considerations worth taking into account when negotiating a job offer from a startup:

- **Cash versus equity.** If your risk tolerance is reasonably high, you might ask for an offer with more equity and less cash. If a company begins to do well, it'll likely "level up" lower salaries (bringing them closer to market average) even if you got more equity up front. On the other hand, if you ask for more cash and less equity, it's unlikely you'll be able to negotiate to get more equity later on, since equity is increasingly scarce over time (at least in a successful company!). Entrepreneur and venture capitalist Mark Suster stresses the need to level up by scaling pay and spending, focusing appropriately at each funding stage. In the very early days of a startup, it's not uncommon for employees to have higher salaries than the company's founders.*
- **Title.** Negotiating title and exact details of your role early on may not matter as much in a small and growing company, because your role and the roles of others may change a lot, and quickly. It's more important that you respect the founders and leaders of the company. It's more important that you feel you are respected.

Questions Candidates Can Ask

> COMMON QUESTIONS COVERED HERE
> *What are the most important things to ask after receiving an offer from a startup that includes equity compensation?*
> *What should I know about percentage ownership, valuation, exercising stock options, and vesting when considering an offer from a startup?*
> *What kinds of questions can I ask to understand the benefits and drawbacks of various exercise scenarios?*

◇ IMPORTANT It's important to ask questions when you get an offer that includes any kind of equity. In addition to helping you learn the facts about the equity offer, the process of discussing these details can help you get a sense of the company’s transparency and responsiveness. Here are a few questions you should consider asking, especially if you’re evaluating an offer from a startup or another private company:

- **Percentage ownership.**
  - *What percentage of the company do the shares represent?*
  - *What set of shares was used to compute that percentage? Is itoutstanding shares or fully diluted?*
  - *What convertible securities are outstanding (convertible notes, SAFEs, or warrants), and how much dilution can I expect from their conversion?*
- **Valuation.**
  - *What did the last round value the company at? (That is, what is the preferred share price times the total outstanding shares?)*
  - *What is the most recent 409A valuation? When was it done, and will it be done again soon?*
  - *What exit valuation will need to be achieved beforecommon stock has positive value (that is, what are the liquidation overhangs)?*
- **Stock options.**
  - *Do you allow early exercise of my options?*
  - *Am I required to exercise my options within 90 days after I leave or am terminated? Does the company extend the exercise window of the options of employees that depart?*
- **Vesting.**
  - *Are all employees on the same vesting schedule?*
  - *Is there any acceleration of my vesting if the company is acquired?*
  - *Do you have a policy regarding follow-on stock grants?*
  - *Does the company have any repurchase right to vested shares?*

This information will help you consider the benefits and drawbacks of possible exercise scenarios[§].

◇ IMPORTANT If you’re considering working for a startup, there are further questions to ask in order to assess the state of the company’s business and its plans. Before or when you’re getting an offer is the right time to do this. Startups are understandably careful about sharing financial information, so you may not get full answers to all of these, but you should at least ask:

- *How much money has the company raised (including in how many rounds, and when)?*
- *What did the last round value the company at?*
- *What is the aggregate liquidation preference on top of the preferred stock?* (This will tell you how much the company needs to sell for before the common stock—your equity—is worth something in an exit.)
- *Will the company likely raise more capital soon?*

- *How long will the company's current funding last?* (This will likely be given at the current burn rate, or how quickly a company is spending its funding, so will likely not include calculations for things like future employee salaries.)
- *What is the hiring plan? (How many people over what time frame?)*
- *What is the revenue now, if any? What are the revenue goals/projections?*
- *Where do you see this company in 1 year and 5 years, in terms of revenue, number of employees, and market position?*

There are several other resources with more questions like this to consider.

Typical Employee Equity Levels

> COMMON QUESTIONS COVERED HERE
> *What are some benchmarks for equity compensation levels at startups?*
> *How much should an early-hire engineer expect in equity compensation from a startup?*
> *What are typical ranges for equity in early-stage startups?*

Compensation data is highly situational. What an employee receives in equity, cash, and benefits depends on the role they're filling, the sector they work in, where they and the company are located, and the possible value that specific individual may bring to the company.

Any compensation data out there is hard to come by. Companies often pay for this data from vendors, but it's usually not available to candidates.

For startups, a variety of data is easier to come by. We give some overview here of early-stage Silicon Valley tech startups; many of these numbers are not representative of companies of different kinds across the country:

- ◇ IMPORTANT One of the best ways to tell what is reasonable for a given company and candidate is to look at offers from companies with similar profiles on AngelList. The **AngelList salary data** is extensive.
- There are no hard and fast rules, but for **post-series A startups** in **Silicon Valley**, the table below, based on the one by Babak Nivi, gives ballpark equity levels that many think are reasonable. These would usually be for restricted stock or stock options with a standard 4-year vesting schedule. They apply if each of these roles were filled just after an A round and the new hires are also being paid a salary (so are not founders or employees hired before the A round). The upper ranges would be for highly desired candidates with strong track records.
    - Chief executive officer (CEO): **5–10%**
    - Chief operating officer (COO): **2–5%**
    - Vice president (VP): **1–2%**
    - Independent board member: **1%**
    - Director: **0.4–1.25%**
    - Lead engineer **0.5–1%**

    - Senior engineer: **0.33–0.66%**
    - Manager or junior engineer: **0.2–0.33%**
- For **post-series B startups**, equity numbers would be much lower. How much lower will depend significantly on the size of the team and the company's valuation.
- Seed-funded startups would offer higher equity—sometimes much higher if there is little funding, but base salaries will be lower.
- Leo Polovets created a survey of AngelList job postings from 2014, an excellent summary of equity levels for the first few dozen hires at these early-stage startups. For **engineers** in Silicon Valley, the highest (not typical!) equity levels were:
    - Hire #1: up to **2%–3%**
    - Hires #2 through #5: up to **1%–2%**
    - Hires #6 and #7: up to **0.5%–1%**
    - Hires #8 through #14: up to **0.4%–0.8%**
    - Hires #15 through #19: up to **0.3%–0.7%**
    - Hires #21 [sic] through #27: up to **0.25%–0.6%**
    - Hires #28 through #34: up to **0.25%–0.5%**
- José Ancer gives another good overview for early stage hiring.
- *Founder* compensation is another topic entirely that may still be of interest to employees. José Ancer provides a thoughtful overview.

Typical Startup Advisor Equity Levels

DEFINITION

Advisors are people with extensive or unique experience who help a company in a formal or informal capacity. It is common for startups to bring on advisors with a recognized name, specific background or skills, or access to a network. Sometimes advisors act as mentors to founders.*

Startup advisor compensation is usually partly or entirely via equity. Typical equity levels vary depending on the value the advisor brings, the maturity of the company, and the level of their involvement, which can vary from occasional phone-calls or introductions all the way up to being a kind of part-time, hands-on member of the team.

Because advisors may not add value for as many years as an employee, a common vesting schedule for an advisor is two years with a three-month cliff. Advisor grants also typically have a longer exercise window post termination of service, and will usually have single trigger acceleration on an acquisition, because no one expects advisors to stay on with a company once it's acquired.

One commonly used framework for compensation for advisors is the FAST Agreement from the Founder Institute, an accelerator that's been involved with over 4500 companies. Their approach is to recommend compensation based on the level of engagement (from monthly meetings to hands-on projects and help with networking) and the maturity of the company (from just an idea to growth stage, which would likely mean post-Series A):

	IDEA STAGE	STARTUP STAGE	GROWTH STAGE
Standard (Monthly Meetings)	0.25%	0.20%	0.15%
Strategic (Add Recruiting)	0.50%	0.40%	0.30%
Expert (Add Contacts and Projects)	1.00%	0.80%	0.60%

Source: The Founder Institute's FAST equity compensation framework

Another source is Carta's guide to advisor shares, which similarly shows most grants in the 0.2–1.0% range.

Both the Founder Institute and Carta's guide offer legal templates. Founders and advisors should consult a template and a lawyer before committing to an agreement, but these levels are reasonable reference points for both sides in negotiating fair advisor compensation.

Negotiation Tips

COMMON QUESTIONS COVERED HERE
What are some tips for negotiating a good compensation package with equity?
What tactics can I use to negotiate a better startup job offer?
Is it legal in my state or city for a company to ask about a candidate's current and past salary when making a job offer?

When negotiating a job offer, companies will always ask you what you want for compensation, and you should always be cautious about answering.

If you name the lowest number you'll accept, you can be pretty sure the company's not going to exceed it, at least not by much.

CAUTION Asking about salary expectations is a normal part of the hiring process at most companies, but asking about **salary history** has been banned in a growing number of states, cities, and counties.* These laws attempt to combat pay disparity* among women and minorities by making it illegal for companies to ask about or consider candidates' current or past compensation when making them offers. Make sure you understand the laws relevant to your situation.

A few points on negotiating compensation:

- Some argue that a good tactic in negotiating is to start higher than you will be willing to accept, so that the other party can "win" by negotiating you down a little bit. Keep in mind, this is just a suggested tactic, not a hard and fast rule.

- If you are inexperienced and unsure what a fair offer should look like, avoid saying exactly what you want for compensation very early in discussions. Though many hiring managers and recruiters ask about salary expectations early in the process to avoid risk at the offer stage, some ask in order to take advantage of candidates who don't have a good sense of their own worth. Tell them you want to focus on the opportunity as a whole and your ability to contribute before discussing numbers. Ask them to give you a fair offer once they understand what you can bring to the company.

- If you are experienced and know your value, it's often in your interest to state what sort of compensation and role you are looking for to anchor expectations. You might even share your expectations early in the process, so you don't waste each other's time.

- Discuss what your compensation might be like in the future. No one can promise you future equity, salary, or bonuses, but it should be possible to agree what those could look like *if* you demonstrate outstanding performance and the company has money.

- If you're moving from an established company to a startup, you may be asked to take a salary cut. This is reasonable, but it's wise to discuss explicitly how much the cut is, and when your salary will be renegotiated. For example, you might take 25% below your previous salary, but there can be an agreement that this will be corrected if your performance is strong and the company gets funding.

- ◇ IMPORTANT Always negotiate non-compensation aspects before agreeing to an offer. If you want a specific role, title, opportunity, visa sponsorship, parental leave, special treatment (like working from home), or have timing constraints about when you can join, negotiate these early, not late in the process.

- ◇ IMPORTANT If you're going to be a very early employee, consider asking for a restricted stock grant instead of stock options, and a cash bonus equal to the tax on those options. The company will have some extra paperwork (and legal costs), but it means you won't have to pay to exercise. Then, if you file an 83(b) election, you're simplifying your situation even further, eliminating the AMT issues[§] of ISOs, and maximizing your chances of qualifying for long-term capital gains tax.

A few notes on the negotiation process itself:

- ◇ IMPORTANT Although offer letters have expirations, it's often possible to negotiate more time if you need it. How much flexibility depends on the situation. Some have criticized "exploding job offers" as a bad practice that makes no sense at all. If you are likely the best candidate for the position, or the role is a specialized and well-paid one where there are usually not enough good candidates to meet the demand, you'll likely have plenty of leverage to ask for more time, which may be needed to complete the interview process with other companies. Software engineering roles in tech companies are like this currently.

- Getting multiple offers is always in your interest. If you have competing offers, sharing the competing offers with the company you want to work for can be helpful, granted your offers are competitive.

    - However, dragging out negotiations excessively so you can "shop around" an offer to other companies is considered bad form by some; it's thoughtful to be judicious and timely to the extent that it's possible.
- ⚠ DANGER Get all agreements in writing, if they are not in your offer letter.
- Do not accept an offer verbally or in writing unless you're ready to stand by your word. In practice, people do occasionally accept an offer and then go back on it, or *renege*. This can put the company in a difficult position (they may have declined another key candidate based on your acceptance), and may hurt your reputation in unexpected ways later.

Some additional resources:

- Harvard Business Review has a variety of general 💰 PAID suggestions on negotiation processes.
- Robby Grossman, a VP at Wistia, gives a good overview of equity compensation and negotiation suggestions in startups.

Offer and Negotiation Dangers

COMMON QUESTIONS COVERED HERE
What are significant dangers to be aware of when negotiating job offers with equity compensation?
What are some common mistakes to avoid when negotiating a startup job offer?
What are the most serious pitfalls with exercising and vesting when evaluating an offer with equity compensation?

To wind up our discussion of offers and negotiations, here are some key dangers and mistakes to watch out for:

- ⚠ DANGER Do not accept an offer of stock or shares without also asking for the exact number of total shares (or, equivalently, the exact percentage of the company those shares represent). It's quite common for some companies to give offers of stock or options and tell you only the number of shares. Without the percentage, the number of shares is meaningless. Not telling you is a deeply unfair practice. A company that refuses to tell you even when you're ready to sign an offer is likely giving you a very poor deal.
- ◈ CAUTION If you're looking at an offer, work out whether you can and should early exercise, and what the cost to exercise and tax will be, before accepting the offer.
- ⚠ DANGER If you join a startup right as it raises a new round, and don't have the chance to exercise right away, they may potentially issue you the options with the low strike price, but the 409A valuation of the stock will have gone up. This means you won't be able to early exercise without a large tax bill. In fact, it might not be financially feasible for you to exercise at all.
- ⚠ DANGER Vesting starts on a vesting commencement date. Sometimes stock option paperwork won't reach you for weeks or months after you join a company, since it needs to be written by the lawyers and approved by the

board of directors. In your negotiations, do make sure the vesting commencement date will reflect the true start date of when you joined the company, not the time at which the stock option is granted.

- CAUTION The offer letter is not the actual grant of your equity. After you sign your offer letter, ensure the company delivers you your actual equity grant documents within a few weeks. It is not uncommon for early-stage startups to be sloppy with their equity granting. If they take too long to send your grant documents, the fair market value (and exercise price) of the equity could rise in the time you're waiting, which is money lost for you.
- CAUTION If you're going to early exercise, consider it like any investment. Don't believe every projection about the value of the company you hear. Founders will tell you the best-case scenario. Remember, most startups fail. Do your research and ask others' opinions about likely outcomes for the company.
- DANGER It may not be common, but some companies retain a right to repurchase (buy back) vested shares. It's simple enough to ask, "Does the company have any repurchase right to *vested* shares?" (Note repurchasing *unvested* shares that were purchased via early exercise is different, and helps you.) If you don't want to ask, the fair market value repurchase right should be included in the documents you are being asked to sign or acknowledge that you have read and understood. (Skype's controversy related to repurchasing has some startup employees looking out for companies with similar plans.) You might find a repurchase right for vested shares in the Stock Plan itself, the Stock Option Agreement, the Exercise Agreement, the bylaws, the certificate of incorporation, or any other stockholder agreement.

Documents and Agreements

8 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

What kinds of documents should I expect to sign as part of my equity compensation package?
What do stock plan and stock option agreements look like?
What does an exercise agreement cover?
Show 2 more

This section covers a few kinds of documents you're likely to see as you negotiate a job offer and sign on to a company. It's not exhaustive, as titles and details vary.

- When you are considering your offer, make sure you have all of the documents you need from the company:
  - Your DOCUMENT offer letter, which will detail salary, benefits, and equity compensation.
  - An DOCUMENT Employee Innovations Agreement, Proprietary

Information and Inventions Assignment Agreement, or similar, concerning intellectual property.

- If you have equity compensation, at some point—possibly weeks or months after you've joined—you should get a Summary of Stock Grant, Notice of Stock Option Grant, or similar document, detailing your grant of stock or options, along with all details such as number of shares, type of options, grant date, vesting commencement date, and vesting schedule. It will come with several other documents, which may be exhibits to that agreement:
  - DOCUMENT Stock Option Agreement
  - DOCUMENT Stock Plan (sometimes called a Stock Option Plan, or Stock Award Plan, or Equity Incentive Plan)
  - DOCUMENT Code Section 409A Waiver and Release (sometimes part of the Stock Option Agreement)
- If you are exercising your options, you should also see paperwork to assist with that purchase:
  - DOCUMENT Exercise Agreement
  - Instructions and template for early exercise and DOCUMENT 83(b) election, if applicable.
- End of year tax documents
  - You should receive a form DOCUMENT 3921 or 3922 from your company if you exercised ISO options during the year.

Further Reading

5 minutes, 49 links

GIVE THIS CHAPTER

COMMON QUESTIONS COVERED HERE

What are the best online resources for understanding equity compensation?
Where can I find a comprehensive reading list on equity compensation?
What are essential readings on equity compensation?

The resources here are a small subset of the full set of resources cited in the Guide to Equity Compensation, selected for their breadth, notability, or depth on specific issues.

General Resources

- Mark P. Cussen, Investopedia, *Introduction To Incentive Stock Options*, updated 2017
- Alex MacCaw, *An Engineer's Guide to Stock Options*, 2013
- Andy Rachleff, Wealthfront, *The 15 Crucial Questions About Stock Options*, 2018

- Mary Russell, Stock Option Counsel, *Startup Equity Standards: A Guide for Employees*, 2014
- David Weekly, 💰 PAID *An Introduction to Stock & Options for the Tech Entrepreneur or Startup Employee*, 2012
- Investopedia, *What Is an Employee Stock Option (ESO)?*

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Who contributed to the Holloway Guide to Equity Compensation?

Who are the original authors of the Holloway Guide to Equity Compensation?

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