

Initial Public Offerings: Leading Financial Advisors On Equity Compensation Planning

myStockOptions.com Contributors & Editorial Team

Key Points

1. IPOs bring many risks: risk of internal changeups and team member departures, risk of volatility in the stock price, and risk of having too much money in one stock. Be aware of the post-IPO lockup period and other trading restrictions.
2. After the lockup, you must decide whether to sell or hold the shares. Ask yourself: if your company paid you a large cash bonus, would you use it to buy company stock?
3. One way to simplify the sell/hold decision is to map your future capital liabilities on a timeline. A financial planner can help with your decision-making process and with tax planning.

An initial public offering (IPO) presents unique planning circumstances for employees with equity compensation and holdings of company shares. Before your company goes public, you need to understand what will happen and what you need to prepare for. We asked several leading financial advisors, from a variety of US regions, for their ideas on pre- and post-IPO planning. Below are their responses, presented in their own words. For additional advisor insights into IPO planning, see another article on this website, *Stockbrokers' Secrets: 5 Financial-Planning Insights For Equity Compensation At IPO Companies*.

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► **Meg Bartelt, CFP®**

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It's critical to make a strategy for an IPO that you can adapt to whatever the stock price is, without letting emotion drag you all over the place. At Flow, we helped 11 clients prepare for and go through the initial stages of Airbnb's IPO. I learned some lessons from that experience. I hope they will help your IPO experience be better organized, less stressful, and strategic.

1. NOBODY KNOWS WHAT WILL HAPPEN. This is true of any

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stock, and especially when the stock has no price history. Only a week before Airbnb's IPO, our Airbnb clients were expecting \$50 per share. The stock was priced at \$68 when it went out, started trading at \$146, fell to \$125, and then rose slightly above \$155.

2. An IPO plan is essential, even if you abandon most of the details. Flexibility is key. The ultimate point of a plan is to support whatever goals or intentions the plan was created for—not to rigidly stick to the plan no matter what. Sometimes changing the execution of your IPO plan as the facts change results in something even better.

3. The IPO is going to be stressful. Prepare for it. Unless you're some sort of Zen master, I don't think there's any way to avoid being stressed. Arrange some emotional support ahead of time. Take the day, or at least a few hours, off from work. And at the risk of sounding self-serving, find a financial planner.

4. Prepare for an administrative clusterf*ck, especially if there's anything unusual about the IPO. What Airbnb did with their IPO (allowing its employees to sell 15% of their shares during the first seven days) was a first, to my knowledge. It was only rational to expect it to not work smoothly. I'm delighted it turned out as well as it did. But set your expectations appropriately. Keep your strategy as simple as possible. Every bit of complexity is inviting the Gods of Administrative Hell to come screw with you.

5. Setting RSU tax-withholding isn't the end of your tax issues. While Airbnb let employees choose the RSU tax-withholding flat rate (either 22% or 37%), that may not be the end of the tax issues when the stock-sale price (maybe as high as \$155) is much higher than the IPO price used for the withholding (\$68). Capital gains tax could still trigger the need to pay estimated taxes.

6. Trading on Day 1 is especially hard. IPOs usually have a lockup of 180 days, so by the time you can sell your shares you have at least some stock-price history to base decisions on. Going into Airbnb's IPO, knowing we could trade on Day 1, it was a total crapshoot. If your IPO is like that, make a strategy that can adapt to whatever the stock price is.

For more details on each of these lessons, see my article *Lessons From Airbnb's IPO*.

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With double-trigger RSUs at a private company, you meet both criteria for vesting when: (1) you satisfy the time requirement (e.g. 25% of the grant vests every 12 months) and (2) your company had a liquidity event (e.g. IPO). After tax withholding and the lockup period, your next steps are to decide what to do with the after-tax

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shares and any shares resulting from future RSU vesting. Below I discuss the top two comments I hear from clients and prospects.

"I want to keep my shares because I believe in my company's prospects." Some people might keep their company stock because they can afford the risk. For example, if you want to work forever, you can attain your financial goals even if your company stock price drops by a large percentage.

However, I reframe the issue as follows: "If your company paid you a large cash bonus, would you use this money to purchase company stock?" If your answer is no, you should think of the RSU "payment" as a bonus that happened to be paid in shares rather than cash. In other words, sell all of the shares immediately; your company will withhold taxes, and you keep the remaining cash.

"I want to keep my shares for at least one year to save on taxes." It's true that when you hold a capital asset for more than one year, long-term capital gains are taxed at a special lower rate. Short-term capital gains are taxed at regular income tax rates, which are higher. But remember that there are two sets of taxes for RSUs:

- You pay taxes on the value of the RSUs at vesting (income taxes)
- You pay taxes again when you sell the shares acquired from the vested RSUs (capital gains taxes)

Clients often focus on capital gains taxes. Don't forget the first set: you've already paid federal and state income taxes based on the stock's value at vesting. And you may owe a balance on your income taxes with your tax return next April. Consult with a tax professional or financial planner to determine how much, if applicable. You can sell enough shares to cover additional taxes owed.

Next, let your goals determine whether to sell some or all of the remaining stock. A financial planner can help you articulate your goals and run a long-term financial projection to compare what you want to achieve (start your own company, downshift to a less stressful job, pay for college, etc.) with your current and future savings. For most of my clients, the long-term projection shows they can achieve their goals if they sell all of the shares and reinvest in a diversified portfolio. In the words of investment expert William Bernstein: "If you've won the game, stop playing."

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How should you plan for taxes on RSUs in an IPO? The truth is that when your vested double-trigger RSUs (restricted stock units) release during an IPO, they're taxed as a cash bonus, whether you sell them or not. So even if you decide not to sell, you'll still have a big tax bill

after-tax shares. I reframe the issue as follows: "If your company paid you a large cash bonus, would you use this money to purchase company stock?"

When vested double-trigger RSUs release during an IPO,



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to pay in April. There's nothing worse than realizing you owe thousands in taxes that you didn't budget for, so this is where tax planning comes into play.

Calculate your RSU supplemental wages and the new tax bracket they put you into. Supplemental wages include the money you make when your RSU shares release at IPO. What income tax bracket does the additional RSU income land you in? Federal taxes on supplemental wages such as RSUs are withheld at a standard rate of 22%. If the additional RSU income puts you in a tax bracket higher than 22%, your company may not withhold enough on the RSU income.

Don't assume your withholdings are sufficient. Calculate how much you'll owe, and how much extra you'll have to pay on top of what your company withholds.

Two companies with an IPO in 2019 allowed employees to increase withholding, one to 30% and the other to an additional amount chosen by the employee up to 37%.

Adjust your withholding status. On your Form W-4, set your federal allowances to zero. Also, change your status to single. (Yes, even if you're married.) Adjusting these allowances means more will be withheld from your paycheck for taxes, reducing the amount you'll owe from your surplus of RSU income during the IPO. If your company allows, you may also consider withholding more than 22% on supplemental wages.

Make an estimated tax payment out of your profits. With the money you get from selling your RSU shares, make an estimated tax payment. (Or, if you decide to hold your stock and not sell yet, sell just enough to cover your estimated tax bill.) There's no time like the present to go ahead and pay, and after you do, you can use your money worry-free.

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It can be easy to get excited about the possibility of your company IPOing. Not only may a successful IPO lead to increased liquidity for your company stock, a successful IPO with a stock price that goes up in value might lead to the generation of considerable wealth. But before you reap the potential rewards associated with an IPO, it's important to understand the risks involved with an IPO and to consider a few thoughts for your pre-IPO stock options.

First, you should consider whether or not your company will go public at all. Pre-IPO simply means that your company is not currently traded publicly but may do an offer in the future. However, that is not a guarantee that the IPO will come soon or, indeed, ever. Even if your

they are taxed whether you sell them or not. So even if you decide to hold the shares, you will still have a big tax bill.

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company has begun the underwriting process, it's possible that it can be delayed significantly if market conditions change.

If you choose to exercise pre-IPO stock options, you will own shares of a nonpublic company. In some ways this is similar to owning shares of a public company, but in other ways it is different. For example, some private companies may totally restrict your ability to sell pre-IPO shares, and you may need to resell the stock back to the company should you terminate employment early. You may find that you paid for something that you can not turn around and sell, an important consideration when you are doing your financial planning.

If an IPO does occur, the sale of your shares is likely to become much easier and pricing more transparent. However, you should be prepared for a post-IPO lockup period that may restrict the sale of stock. During this period, often six months post-IPO, you may not be able to sell your shares per an agreement your company has with the investment bank (the company helping them go public).

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One of the ways to simplify the sell/hold decision following an IPO lockup period is to map your future capital liabilities on a timeline. The use of the word *liabilities* here indicates any future claim on your capital. It may be eliminating debt, funding an education, making a major purchase, or paying for an annual lifestyle expense. The point is someone has a claim on a portion of your capital, and therefore those amounts cannot be left at risk indefinitely.

The three categories of liability I suggest mapping across the timeline are *Absolute Liabilities*, *Planned And Partially Funded Liabilities*, and *Aspirational Liabilities*. The timeline for each category is as follows:

- **Absolute:** Known, fully funded liabilities payable 0–15 years into the future
- **Planned And Partially Funded:** Known but not fully funded liabilities payable 10–25 years in the future
- **Aspirational:** Expenses or capital investments that you'd like to take on 25+ years in the future but are not yet within reach (and may never be)

One way to simplify the sell/hold decision following an IPO lockout is to map your future capital liabilities on a timeline. Your financial planner can help you quantify the total capital required to fund each of the liabilities in the respective categories.

Your financial planner can help you quantify the total capital required to fund each of the liabilities in the respective categories. They should also be able to help you determine the current excess funding or funding shortfall for any liability on the timeline. You can then make the decision about what portion of your available IPO holdings to sell or hold and how to allocate the proceeds once you have clarity on the



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amounts required and over/under funded status of each liability.

You can also feel more comfortable leaving a certain amount "at risk" in your employer's stock by allocating to your *Aspirational Liabilities* category amounts left over after all other goals on the timeline have achieved a "fully funded" status. Only "unclaimed" capital should be considered eligible to be left at risk.

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IPOs are wild. Sometimes things work out the way we hoped and sometimes they don't. There are many risks: risk of internal changeups and team member departures, risk of volatility in the stock price, and risk of having too much money in one stock. The biggest mistakes I see made with IPO stock include misunderstanding the following:

- When you can do something with your stock
- How you can get caught up in the emotions of an IPO
- What you should consider before the IPO to optimize stock decisions

The biggest mistakes I see with IPO stock are misunderstanding when you can do something with your stock, how you can get caught up in the emotions of an IPO, and what you should consider before the IPO to optimize decisions.

Your company will tell you the target date (or actual date) and target listing price for the shares. Unfortunately, this will still be a theoretical value to you since you won't be able to sell your shares immediately. So when can you do something with your shares? This depends upon the below restrictions your company may have placed on you:

- **Lockup period.** Your company may choose a lockup period at the IPO date to prevent employees from flooding the market with more shares. This generally restricts you from selling shares at IPO and can last up to 180 days.
- **Blackout period and trading windows.** Key employees may not be allowed to trade during specific windows of time before earnings releases on a quarterly basis. This is to prevent insider trading. Your company HR should tell you if you are on this list.
- **Trading restrictions.** Some key employees may not be allowed to freely trade shares at any point. This results in pre-clearance of every trade or a requirement for you to have a longer-term trading plan in place. Known as a Rule 10b5-1 trading plan, this type of plan is filed with the SEC and your company. Verify these restrictions with your company now so you know what you can expect. Some companies provide trading calendars as well to make it more clear for you.

What should you consider before the IPO to make better decisions with your stock? We take all clients



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through the exercise of preparing:

- Gather your stock docs: grant summaries, stock option plan document, history of outstanding grants and shares, prior exercise information, etc.
- Create a cost basis tracker for everything you've done to date with your stock.
- Review past tax returns to see if you paid alternative minimum tax (AMT) on an incentive stock option (ISO) exercise.
- If you did, look for the AMT credit you can carry forward to future years and make sure it didn't get lost along the way (a big thing we see happen with tax returns).
- Take another look at exercising some ISOs before trading halts pre-IPO. Consider the risks, taxes due, and whether you can personally make the commitment to the strategy. We definitely recommend doing this part with an expert.

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