THE NORTHERN TRUST INSTITUTE

PREPARING FOR IPO-GENERATED WEALTH

A SUCCESSFUL IPO OFTEN RESULTS IN A TIDAL WAVE OF WEALTH. ARE YOU PREPARED TO MAKE THE MOST OF IT?

The U.S. Initial Public Offerings (IPOs) market is setting new records in 2021 with IPOs up more than 650% compared to a year ago, according to FactSet. With private company valuations and the market both reaching new heights, this momentum is expected to continue through the end of the year and likely beyond.

For founders, employees and early investors, preparing for the IPO itself can be exciting, yet all-consuming. As your company prepares to cross the elusive milestone of going public, many questions may arise as you prepare for a personal influx of wealth. Some of the questions we commonly get from clients include:

01 How much will I owe in taxes?

02 What rules and restrictions will I be subject to?

03 What should I consider for short- and long-term wealth planning?

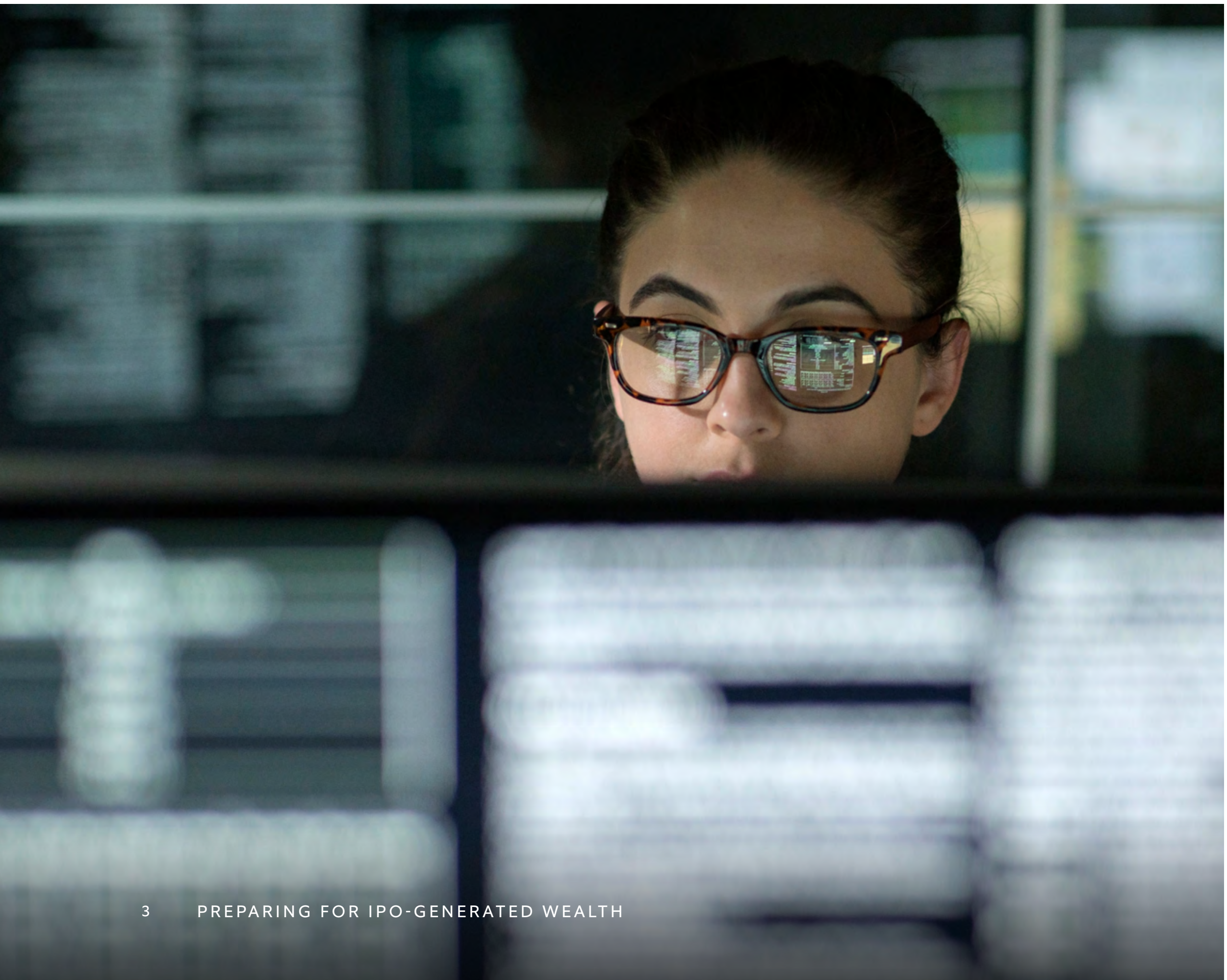
04 Are there different estate planning strategies I should consider?

A post-IPO concentrated stock position is likely to represent a significant portion of your net worth and may require a different approach than your current wealth plan. Aside from an increase in wealth, when your private company ownership interests, founder's stock or options convert into common shares, you will face a new set of complex regulatory restrictions. Having a clear view of how this influx of wealth affects your long-term goals is critical to your future financial success. Ideally, this can be accomplished with careful planning to address regulatory restrictions and corresponding tax implications.

THE FIRST STEP

Before addressing these questions, it is important to take stock of your grants and awards.

- Locate plan documents and grant agreements.
- Identify the specific type of grant — e.g., non-qualified stock options (NQSOs), incentive stock options (ISOs), restricted stock, restricted stock units (RSUs) or founding term shares.
- Inventory outstanding grants, awards and shares by date and quantity.
- Confirm the vesting status (e.g., unvested, partially vested or fully vested).
- Notate prior exercise history.



HOW MUCH WILL I OWE IN TAXES?

Equity-linked compensation, stock options and related awards provide the unique ability to control the timing of income recognition by allowing you to dictate the exercise of options and eventual sale of company stock holdings. You may find that a multi-year recognition strategy will result in vast tax savings, depending on your cash needs and flexibility. Consider the following four action items as you work with your tax advisor to calculate your potential tax liability.

Evaluate the exercise of stock options

Pre-IPO companies sometimes permit the early exercise of unvested stock options. In many cases, it may be advantageous to exercise early while there is nominal gain on the spread. In addition, exercising early converts future appreciation from ordinary income to capital gains and starts the clock toward a long-term holding period. There is a risk that the shares could decrease in value, making thoughtful analysis and careful planning paramount in developing an option exercise strategy.

Confirm past Section 83(b) elections

In recent years, restricted stock or RSUs have become increasingly more common than stock options. With RSUs, upon vesting (i.e., when the stock is owned), the value of the stock is taxed as compensation income. However, for stock expected to significantly appreciate, often recipients avail themselves of a Section 83(b) election of the Internal Revenue Code, which permits payment of the tax liability at the time of grant versus when the shares later vest. Past elections and tax payment will impact your basis in the stock, which is important to estimate future tax liability when the underlying stock is eventually sold.

Plan for potential double-trigger vesting of RSUs

As explained above, RSUs are taxed upon vesting. Because private company stock cannot be sold in the open market, shareholders (oftentimes employees) may be forced to use personal cash reserves to pay income tax on vested RSUs. To prevent this, some pre-IPO companies grant “double-trigger” vesting RSUs, with the first condition satisfied after a stated time period and the second upon a liquidity event such as an IPO. Carefully review your stock plan documents to understand how soon post-IPO a tax event may occur for you.

Determine applicability of QSBS

You may not owe federal tax on all or a part of the gain from the sale of stock in your company. Section 1202 Qualified Small Business Stock (QSBS) exemption of the Internal Revenue Code presents significant tax savings for individuals who start and invest in small businesses that are domestic C corporations. In short, it permits the exclusion from tax of up to $10 million, or 10 times your tax basis, whichever is greater. It is important to understand the QSBS exemption requirements and nuances — for the company as well as your holding requirement based on the type of award issued. Last, the extent of a particular state's conformity to federal tax law will need to be addressed separately, whereas certain states either modify or completely disallow the exclusion.

WHAT RULES AND RESTRICTIONS WILL I BE SUBJECT TO?

Once the company is public, you will be subject to restrictions from the company, underwriters and potentially the SEC if you are deemed an insider. It is best to understand the full scope of restrictions and associated limitations on your ability to liquidate your concentrated stock holding.

Prepare for lockup

Pre-IPO, take the time to model various scenarios that reflect multiple price targets to manage expectations and emotions. Immediately following an IPO, early investors, employees and insiders are often prohibited from selling their stock for a specified period, typically 180 days. Some companies implement multiple or tiered lockups with different expiration periods, permitting the sale of a predetermined quantity of shares during a set time. No matter the time frame, during the lockup period the price often fluctuates, which may have a varying impact on your wealth and tax liability.[1]

Be aware of blackout periods and trading windows

Determining the best time to purchase and sell stock is never easy and will be even more difficult as you strive to manage liquidity or reduce your single-stock exposure. Typically, insiders are limited to trading windows outside of "blackout periods." It is important to obtain a trading calendar from your company to understand when you can freely trade.

Execute a Rule 10b5-1 plan to manage ongoing trading restrictions

Maintaining compliance with limited trading windows may prove difficult. For that reason, it is advantageous to establish a trading plan to permit future trading at any time, even during blackout periods. An SEC Rule 10b5-1 plan permits the purchase and sale of stock at a predetermined time and price. Once established, the plan remains in effect even when you are aware of material, nonpublic information. Most importantly, a properly executed Rule 10b5-1 plan becomes an affirmative defense against allegations of insider trading.

1. NASDAQ research on the IPO market confirms that post-IPO price fluctuations are common and may persist for months to even years as investors reprice enthusiastic pre-IPO growth expectations for the slower-growing reality once the company begins publicly reporting earnings.

WHAT SHOULD I CONSIDER FOR SHORT- AND LONG-TERM WEALTH PLANNING?

A large concentration of company stock introduces risk and complexity into an employee, executive or investor's wealth plan. The inherent risk cannot be ignored — potential volatility in the stock price that represents the overwhelming majority of one's portfolio. The biggest decision you will make is whether to hold, sell to spend, sell to diversify, or apply a laddered approach to diversify the stock over time.

Use a timeline to define your goals

This may be your first experience with substantial wealth. Or perhaps it is yet another attractive liquidity event. Whatever the case, reflecting on your goals will be instrumental in shaping your wealth plan. One way to demystify the sell versus hold decision is to map out and quantify your financial needs and goals. Gaining clarity about when you need to address debt, fund education, purchase a home or pay for an annual expense will help formulate a plan to ensure your stock provides asset sufficiency over your lifetime.

Devise a diversification strategy

Although you are likely passionate about the company and its future success, it is important not to allow your confidence to overshadow the potential risk of your concentrated holding position. From time to time, ask yourself, "If I received a cash bonus worth the same amount, would I use it all to purchase company stock?" At some point, you must release loyalty to embrace diversification. As is the case with all stock, future value is unknown. But value is even more elusive for a stock that has no price or trading history. Based on your defined timeline of objectives and required cash outlays, devise a strategy to invest a portion of your wealth in assets other than your company.

Engage experts

There are few decisions along your journey as important as determining whose advice you will rely on. Selecting a team of advisors is both art and science, and one of the most critical steps to protect your wealth and achieve your goals. When evaluating advisors, consider expertise, experience and empathy. In addition to selecting advisors and firms who are equipped to adapt to the evolving complexity of your needs, it is important that the team communicates well, collaborates rather than competes and, most importantly, is aligned with your goals, risk-tolerance and the nuances of your specific needs.

ARE THERE DIFFERENT ESTATE PLANNING STRATEGIES I SHOULD CONSIDER?

While wealth planning for large stock positions is challenging, incorporating that into an estate plan is equally complex. Federal securities law can affect the utility and consequences of estate planning transfer vehicles, making it an imperative to work with advisors and trustees who are familiar with securities rules to spot issues and anticipate registration requirements, reporting requirements and transfer restrictions.

Gift now rather than later

For 2021, the historically high lifetime exemption amount for gift, estate and generation-skipping transfer taxes is $11.7 million per person ($23.4 million for married couples). If you have the ability and desire to transfer significant assets to future generations, you may find that gifting sooner rather than later is advantageous. The lifetime exemption amount is set to revert to $5 million per individual, indexed for inflation, in 2026. You may be hesitant to transfer your company stock to another so quickly; however, a gift of company shares to a trust may allow you to retain some level of control, depending on its structure.

Fund a GRAT

A grantor retained annuity trust (GRAT) presents one of the best ways to transfer company stock likely to appreciate in the future. Any appreciation of assets held by the GRAT above the applicable IRS 7520 rate in effect at funding will pass to beneficiaries free of any gift or estate tax. Today's applicable IRS 7520 rate is near the historic low, making this an ideal time to create a GRAT. Last, if structured properly, the value of stock transferred to a GRAT is not counted against your allowable lifetime gift exemption.

Donate to charity

For many, charitable giving is a high-priority goal. A donation of appreciated stock held long-term maximizes your gift since neither you nor the charity will have to pay capital gains tax on the stock. As you begin to develop your philanthropic goals and legacy, be careful not to donate stock received on ISO exercise until the disqualifying disposition has passed (i.e., one year post-exercise and two years post-grant). Likewise, be mindful that stock held for less than one year will yield a deduction cost basis or current fair market value, whichever is lower.

ADDITIONAL CONSIDERATIONS

In addition to these considerations, carefully review your existing estate plan documents to ensure your newfound wealth is incorporated as desired. To ensure your plan will unfold as intended, learn more about The Northern Trust Institute's approach to Planning with Purpose and stress testing your plan.

PRE-IPO PLANNING CHECKLIST

The following provides a list of considerations to keep in mind as you prepare to navigate the lockup period and stock value fluctuations to create a strategy for your concentrated stock position that aligns with your objectives.

Take stock

Prior to making any important decisions, take stock of your grants and the attributes of each.

- ☐ Locate plan documents and grant agreements
- ☐ Identify the specific type of grant— e.g., non-qualified stock options (NQSOs), incentive stock options (ISOs), restricted stock, restricted stock units (RSUs) or founding term shares
- ☐ Inventory outstanding grants, awards and shares by date and quantity
- ☐ Confirm the vesting status (e.g., unvested, partially vested or fully vested)
- ☐ Notate prior exercise history

Engage experts

Assemble a team of advisors equipped to adapt to the evolving complexity of your needs.

- ☐ Tax advisor
- ☐ Tax preparer
- ☐ Wealth advisor
- ☐ Trusts and estates attorney

Conduct a tax assessment

Consult a tax advisor for an assessment and strategy session to plan for your tax liability.

- ☐ Evaluate exercise of stock options
- ☐ Confirm past Section 83(b) elections
- ☐ Determine whether RSUs have "double trigger" vesting conditions
- ☐ Determine Section 1202 Qualified Small Business Stock exemption applicability

Prepare for lockup and ongoing restrictions

Be aware of the full scope of restrictions and associated limitations on your ability to acquire and liquidate your company stock.

- ☐ Understand whether your lockup period is a single specified period or tiered
- ☐ Model various scenarios that reflect multiple price targets to anticipate price fluctuation
- ☐ Obtain the trading calendar from the company to understand when you can freely trade
- ☐ Evaluate establishing an SEC Rule 10b5-1 plan to permit future trading at a predetermined time

Develop your financial strategy

A large concentration of company stock introduces risk and complexity into your wealth plan that cannot be ignored.

- ☐ Define your short-term goals and long-term objectives
- ☐ Map out your financial needs and desires on a timeline to project immediate and future cash outlays
- ☐ Devise a diversification strategy for your concentrated stock position

Create a comprehensive estate plan

Work with advisors and trustees who are familiar with securities rules to spot issues and anticipate registration requirements, reporting requirements and transfer restrictions applicable to estate planning.

- ☐ Review and update your will, revocable trust, powers of attorney and healthcare directive
- ☐ Evaluate your ability and desire to give now rather than later, given historically high lifetime exemption amount[2]
- ☐ Incorporate trust and transfer vehicles for children and spouse
- ☐ Evaluate whether to fund a grantor retained annuity trust for company stock believed to appreciate in the future
- ☐ Develop philanthropic and legacy goals and determine whether to donate appreciated stock in the future

2. For 2021, the historically high lifetime exemption amount for gift, estate and generation-skipping transfer taxes is $11.7 million per person ($23.4 million for married couples). If you have the ability and desire to transfer significant assets to future generations, you may find that gifting sooner rather than later is advantageous, since the lifetime exemption amount will revert to the prior $5 million limit in 2026, or potentially shrink even lower if new tax legislation is enacted.

HOW NORTHERN TRUST CAN HELP

IPO-generated wealth and equity-linked compensation demand technical expertise and effective, targeted financial planning. Our Executive Advisory Services experts understand the issues and complexities you will likely face, and are dedicated to helping you achieve your financial, tax, estate and philanthropic objectives.

ABOUT THE NORTHERN TRUST INSTITUTE

The Northern Trust Institute is a research center dedicated to advising affluent families. More than 175 experts collaborate across 34 areas of expertise to analyze behavioral patterns and identify the strategies that have been most effective for our clients — bringing the breadth and depth of our firm to each unique situation. The resulting insights position you to take action with confidence and achieve optimal outcomes with your wealth.

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