EQUITY and VESTING

Many businesses are started when several co-founders or co-investors come together around an idea that they think is going to be profitable. Sometimes not all of the co-investors bring the same value to the business as one another. One investor may be putting up half of the money but almost no work, while the other three are putting in all the work and only one-sixth of the money each, for instance. In these scenarios, it is important to decide how to divide up the ownership stakes of the company, and establish a vesting schedule to encourage all of the investors to stick around and make it successful. One You should be thinking about is how you want to divide and allocate the company's equity, and what the terms will be for that allocation.

DIVIDING EQUITY

There are many ways to divide equity and work out a vesting schedule. Some people split equity up evenly between all co-founders, while others allocate equity based on whose idea really started the company. You should consider those issues, as well as each co-founder's future role in the company, how much work each is contributing to the business, and future employees of the business. Sometimes "sweat equity" turns out to be more valuable than cash when starting a business, and many companies reflect that value system in the way they divide equity.

Sometimes a founder may want to receive little or no early salary in exchange for more equity. This is generally a bad idea, because it is very difficult to calculate the proper exchange, and this practice can raise a number of issues with tax and accounting later on. You should also avoid allocating equity based on the amount of control each co-founder has over business decisions. In fact, you should have an entirely separate agreement that outlines how the business will make decisions.

It may seem like a good idea to tie equity allocation to the amount of capital contributed by each co-founder, but it is usually better to allocate equity based on so-called "sweat equity," or the amount of work each co-founder is really putting in to the business or will contribute. Instead of letting one large capital contribution earn a co-founder a larger slice of equity, it is probably better to give that person some convertible debt or preferred stock in exchange for their extra capital. As it turns out, starting a business requires a lot of money, but even more work. The founders who do the work are probably providing more value over the long term than the founder who just supplies cash, even though that cash is critical.

VESTING

After you decide how to split up the company's equity, you will also need to determine a vesting schedule. A vesting schedule is an agreement laid out in advance that specifies how much of their equity allocation each co-founder actually owns at any point of time. For example, say the agreement is that shares of equity vest over a four-year period at 25% per year. This means that each co-founder only actually "owns" 25% of their total equity at the end of the first year, 50% at the end of the second year, 75% at the end of the third year, and 100% at the end of the fourth year. This encourages people to stick around and stay engaged in seeing to the success of the business. If someone wants to leave early, they have to accept only a percentage of their equity.

There are many ways to devise a vesting schedule. You might want 25% to vest immediately, and then 10% more to vest each quarter, for instance, or simple yearly vesting at non-uniform percentages: 20%, 30%, 50%. Part of your business plan should address the vesting schedule, and that schedule should be based in part on the predicted health of the company at various points. You can also include acceleration clauses in your schedule to allow for rapid vesting in certain circumstances, like an acquisition of the company or a termination without cause. Vesting can be helpful mechanism to maintain the interest of talented founders throughout the lifecycle of the business.

Capital Gains and Schedule D

Capital gains are basically income you receive from the sale of an investment asset. If you bought a share of stock in a company for $20, and sold that same share of stock a year later for $50, you would have realized $30 in capital gains. Capital gains (or losses) are taxed differently than normal income.

A “Schedule D” is an income tax form filed by investors to report any realized capital gains or losses. Keep in mind that while an investor simply holds an asset, but does not sell it, they do not need to file a Schedule D for that asset. This is true even if an investor’s shares appreciate in value year over year. It is only when an investor sells the asset and realizes a gain or loss they need to file a Schedule D. If you made money, you will need to pay taxes on those capital gains. If you lost money, you can deduct some of that loss from your tax burden.

Dividends are among the type of income that might require a Schedule D submission. This is because dividends are now subject to a capital gains tax instead of a normal income tax.

In addition to your business investments, there are some situations in which you need to file a Schedule D for gains made from the sale of personal property. This is only when you hold personal property like a home, car, or artwork, and you sell it for a gain. If you sell those items for a loss, you generally do not need to file a Schedule D, because that loss is not deductible.

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