THE VELD GROUP VELD MERGERS & ACQUISITIONS

The Incentive Stock Option (ISO) Plan

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Business owners who set up employee incentive plans generally do so to motivate their employees to work harder and smarter. Owners engaged in The Seven Step Exit Planning Process™, however, use employee incentive plans to accomplish a number of additional purposes:

1. To motivate the Employee to increase the value of the company.
2. To retain the Employee through the owner's exit from the business.
3. To reward the Employee for performing (currently and in the past) at a superior level.
4. To begin transferring ownership in anticipation of an owner's physical departure from the company. (The decision to transfer to insiders is made early in The Exit Planning Process.)

There are several types of equity-based incentive plans owners can use to achieve these purposes. Today, let's look at how a fictional owner used one type, the Incentive Stock Option Plan to help achieve his ownership objectives.

Stan Bartholomew was the sole owner of Bartholomew Glass, a manufacturer of commercial tempered glass. At age 50, he had decided that while he'd had a great run, (building the company from only 10 employees to more than 100) he did not want to die at the plant. He'd assembled a crack management team that, given the chance, could run the operation. Stan didn't believe he could sell to a third party—given the lack of M&A activity in his industry—and really preferred to pass the company to employees with whom he'd worked for years. Stan felt that his employees were receptive to the idea so he wanted to know what to do next.

Stan's advisors first probed Stan's belief that his employees wanted to own the company. At least four of Stan's key people had expressed interest in purchasing ownership if Stan were ever to offer/sell it.

Second, we needed to know if Stan's key employees were really capable of running the operation. We brought in a Management Consultant to analyze this question and she reported that, with the exception of sales, Stan's key employees could indeed carry on without him.

At this point, we suggested to Stan that he implement an Incentive Stock Option Plan.

First, Bartholomew Glass would grant 50 (of the outstanding 500) shares to each of Stan's four key employees. Each employee would have to exercise his/her option to purchase those shares within 10 years. At the date of exercise, each employee would pay the original Grant Price and incur no tax consequences. When the employee subsequently sells that stock, the employee would pay capital gains tax on the growth in value over the Grant Price provided that s/he had met the holding period requirements (the later of: (1) two years from the grant or (2) one year from the date of exercise of the option by the Employee).

Stan liked the idea of the ISO because he could motivate key employees without draining company cash and because it was such a good deal for his employees. (None of them had much cash to buy him out, but all had been loyal and productive for years.)

We pointed out to Stan that using an ISO had several drawbacks: 1) there were several Internal Revenue Code requirements that limited what the Plan could and could not do; 2) it did nothing to handcuff his employees during the grant period; 3) there were no tax benefits to Stan's company; and 4) if the company repurchased the stock after the exercise, it would so with after-tax dollars.

What works best for you, for your company and for your key employees?

Stan looked at the pros and cons and decided that this type of plan's failure to handcuff employees to the company and the fact that his company would have to repurchase stock with after-tax dollars outweighed its benefits. He wondered if there was another type of equity plan that would achieve the same goals with fewer drawbacks.