

## The Non-Qualified Stock Option Plan

Stan Bartholomew was a 50-year old business owner who wanted to motivate his key employees while beginning to transfer them stock. After reviewing the pros and cons of an Incentive Stock Option Plan (ISO), Stan wanted an alternative.

Stan wanted the alternative to achieve the same goals (to motivate his key employees to increase the value of the company; to retain those employees through his exit from the business; to reward the employees for performing (currently and in the past) at a superior level; and to begin transferring ownership in anticipation of his physical departure from the company.

While Stan liked the idea of motivating key employees without draining company cash flow, he did not want to be bound by the statutory requirements of the Incentive Stock Option Plan so we suggested a Non-Qualified Stock Option Plan.

Under this plan, the company would grant employees an option to acquire a specific number of shares (limited to a specific time period and at a pre-determined price). Unlike the ISO, employees would be taxed (at ordinary income rates) on the difference between the Fair Market Value of stock and the exercise price at the time of the exercise. Stan's company would receive a corresponding deduction. Like the ISO, if the employee would leave, the stock would be usually redeemed by Stan's company.

On balance, the Non-Qualified Stock Option Plan potentially offers the same benefits to the company and to the employees as does the ISO, provided the company pays each employee a cash bonus at the date of exercise and the company has taxable income.

The words "cash bonus" immediately caught Stan's attention. We explained that some employers choose to "gross up" the stock bonus with cash in an amount sufficient to pay the employee's tax on the stock bonus and the cash bonus.

Let's assume that the company bonuses Employee A \$40,000 in stock. If the company bonuses the employee about \$17,000 in cash, Employee A will have no out-of-pocket tax costs and the company



**Michael Wildeveld, CEPA, M&AMI,  
CM&AP, CM&AA, CBI, CBB**  
[michaelw@veldma.com](mailto:michaelw@veldma.com)

**Veld Mergers & Acquisitions**  
[www.veldma.com](http://www.veldma.com)  
1 Park Plaza, 600  
Irvine, CA 92614  
[310-652-8066](tel:310-652-8066)

receives a tax deduction of \$57,000, resulting in a tax savings of at least \$17,000 (because Stan's company is an S Corporation and is in at least a 30 percent tax bracket).

Like the ISO, the Non-Qualified Stock Option plan fails to handcuff the employees during the grant period, and, if the company repurchases the stock after the exercise, it does so with after-tax dollars.

Without a cash bonus from the company, the Non-Qualified Stock Option plan was not as advantageous to Stan's employees because they would pay tax (at the ordinary income rate) at the date of exercise on the difference between the exercise price (what they paid for the stock) and the Fair Market Value of the stock.

Let's see how the two plans compare:

	Non-Qualified Stock Option Plan	Incentive Stock Option Plan
Grant Price (FMV)	\$100	\$100
Stock Price at Exercise	\$150	\$150
Employee Pays Company	\$100	\$100
Employee Tax Liability	\$50 (ordinary income)	none
Stock Price at Subsequent Sale Date	\$200	\$200
Employee's Basis	\$150	\$100
Tax Treatment	\$50 (capital gains)	

*The information contained in this article is general in nature and is not legal, tax or financial advice. For information regarding your particular situation, contact an attorney or a tax or financial professional. The information in this newsletter is provided with the understanding that it does not render legal, accounting, tax or financial advice. In specific cases, clients should consult their legal, accounting, tax or financial professional. This article is not intended to give advice or to represent our firm as being qualified to give advice in all areas of professional services. Exit Planning is a discipline that typically requires the collaboration of multiple professional advisors. To the extent that our firm does not have the expertise required on a particular matter, we will always work closely with you to help you gain access to the resources and professional advice that you need.*

*This is an opt-in newsletter published by Business Enterprise Institute, Inc., and presented to you by our firm. We appreciate your interest.*

*Any examples provided are hypothetical and for illustrative purposes only. Examples include fictitious names and do not represent any particular person or entity.*