

The Section 83(b) Election

Meet Stan Bartholomew, a 50-year old, sole owner of a successful commercial glass manufacturing company. During Step One of creating his Exit Plan, Stan decided that he wanted to transfer his company to a group of his key employees. He wanted to make this transfer over the next five to seven years. A report from a management consultant indicated that his Key Employee Group (KEG) was indeed willing and able to assume leadership. Our job as advisors was to find a strategy to jump start that transfer in a way in which Stan was comfortable.

Stan rejected both the Incentive Stock Option and Non-Qualified Stock Option plans.

When we suggested the Stock Bonus Plan, however, Stan found two reasons to become very interested. First, Stan liked the idea of forfeiture. We explained that every bonus of stock to an employee could be designed to have a substantial risk of forfeiture. With forfeiture, employees will normally forfeit 100 percent of the bonus if they leave too soon. Over a period of years, that forfeiture lapses in increments. From a "handcuffing" perspective, a 20 percent lapse of forfeiture is equivalent to becoming 20 percent vested in a non-qualified plan. The length of the typical forfeiture arrangement is between 3 and 10 years.

The other aspect of the Stock Bonus Plan that attracted Stan was the 83(b) election. As we explained to Stan, IRS Code Section 83(a) relates to property received for services rendered. It stipulates that such property is taxed as compensation at the Fair Market Value (FMV) of that property.

Section 83 (b) states that an employee receiving restricted stock can elect (in writing and within 30 days of the transfer) to have the ordinary income element "close" as of the date of the election so that any further gain is taxed at capital gain rates. In effect, the employee's ordinary income tax consequence, and the company's corresponding deduction, is the difference between the FMV of the stock and the price paid, if any, by the employee.

The risk to the employee is that if he or she incurs forfeiture after making the 83(b) election, he or she will receive no offsetting deduction. While this employee incurred a tax consequence when he or she made the



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election, once he or she forfeited the stock, that employee does not recapture the tax paid.

In the long-term, the potential disadvantage to Stan's company is the need to repurchase, with after-tax dollars, the bonused stock, at its then current value, should one of his key employees leave after the forfeiture has lapsed.

Once Stan chose the Stock Bonus Plan, (because it furthered his Exit Planning objectives by motivating, handcuffing and rewarding his employees) we helped him make a series of important decisions:

1. As a condition of receiving the stock bonus, would the company require employees to sign covenants not to compete (to the extent permitted under State law)?
2. Which employees would participate at the outset? Could non-participating employees participate in the future?
3. Would Stan select future participants or would he work with a committee consisting of one or more participants?
4. What type of stock would be awarded now and in the future (voting or non-voting)?
5. What valuation formula or written procedure would be used when awarding and re-acquiring stock?
6. What amount of stock would the company award at the outset and in the future?
7. What is the basis (now and in the future) for granting awards?
8. What forfeiture provisions would give Stan the assurance he needed to have his company transfer significant amounts of stock?
9. The company also needed to put in place an agreement to buy back the stock should the employee leave the company.

As you can see, a stock bonus plan for employees is a tool that is well suited to meet many owners' exit objectives. If you have questions about how such a plan applies to your company, or about the many decisions that must be made when deciding what type of plan best suits your exit objectives, please contact me.

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