

# Incentive Options

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## What is an option?

- The right to buy something in the future, usually at a fixed price (the “exercise price” or “strike price”).
- Incentive option: issued by company to stakeholder to purchase company equity

## Who can issue options?

- Most business entities, other than sole proprietorships

## Why issue options?

- Provide cashless (and nearly costless) incentive
- Align interests for growth and exit
- Can vest over time
- Often expected by prospective employees in high-growth spaces
- Can also be used for board, advisors and consultants
- No current dilution
- No current shareholder rights

## Options vs. Restricted Stock

- Generally no tax at issuance
- No current dilution
- No shareholder rights
- No 83(b) filing
- Options give greater incentive to increase value and achieve exit
- No buy-back expense for unvested options

## Tax effect of options

- **Nonqualified (NQSO)**

- No tax at grant if strike price  $\geq$  FMV
- If strike price  $<$  FMV, ordinary income at time of grant on difference
- Ordinary income on difference between strike price and FMV at exercise

## Tax effect of options

- **Qualified (ISO)**
  - No tax at grant if strike price  $\geq$  FMV
  - No tax at exercise
  - Capital gains tax on sale on difference between strike price and sale price

## Qualified options

- Governed by IRC §422
- Only corporations
- Only employees
- 10 year maximum term
- Hold 2 yrs post grant + 1 yr post exercise
- Shareholder approval
- Special rules for >10% stockholders

## Pitfalls

- Determining FMV
- Risk of 409A treatment
- Failure to get shareholder consent (original plan and amendments)
- Not reserving enough stock
- Not allowing flexibility for corporate events
- Not useful in “lifestyle” companies

## Procedure

- Board adopts plan
- Plan submitted to shareholders (ISO only)
- Plan approved by shareholders w/in one year (ISO only)
- Awards approved by board

## Current norms

- 15-25% option pool
- 4 year vesting with one year cliff
- Split on liquidity acceleration

**Questions?**

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