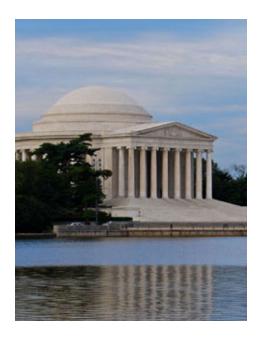


What's News in Tax

Analysis That Matters from Washington National Tax



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Incentive Stock Options—Navigating the Requirements for Compliance

Startup companies, especially in the high tech industry, frequently grant incentive stock options to employees. In recent years, companies have made modifications to their incentive stock option ("ISO") plans due to intense competition for employees. This article discusses two common changes—early exercises and extensions of exercise periods—and the tax ramifications of these changes.

ISOs provide a way to avoid two disadvantages of nonqualified stock options ("NSOs")—the reporting of taxable income at the time of the option exercise and having income treated as compensation. With an ISO, there is no income taxation upon either grant or exercise although the spread (stock fair market value ("FMV") less the exercise price) on exercise is treated as an adjustment for alternative minimum tax purposes. If the stock acquired on exercise is held for at least two years from the date the option was granted and one year after the option was exercised (the "ISO holding period"), then gain on sale of the stock is taxed at capital gain rates. An employee who separates from employment must exercise any ISO the employee holds within three months of termination to retain the ISO status of the options.

Requirements to Qualify Options as ISOs

ISOs must be granted pursuant to a plan specifying the aggregate number of shares to be issued on exercise of the options and the classes of employees eligible to receive the options. Shareholder approval of the plan must be obtained within 12 months before or after its adoption.³ Options must be granted within ten years after adoption of plan (or date of approval by the shareholders, if earlier).⁴ Options generally cannot be granted to an individual owning more than 10 percent of the total combined stock voting

¹ Section 422(a)(1).

² Sections 422(a)(2), 1.421-1(h).

³ Sections 422(b)(1), 1.422-2(b)(2)(i); and proposed sections 1.422-2(b)(3)(i) and (iv).

⁴ Sections 422(b)(2), 1.422-2(a)(2)(ii).

power of the employer corporation or of its parent or subsidiary (certain exceptions apply). The exercise period of an option is generally limited to ten years after grant. The option by its terms must not be exercisable by, or transferable to, any person other than the employee during the employee's lifetime.

The option price must be no less than 100 percent of the FMV of the stock on date of grant.⁸ If a good faith attempt to value the stock to meet the price requirement is made, such price is considered FMV for purposes of this requirement.⁹

Disqualifying Dispositions

To receive favorable tax treatment of ISOs, employees must meet the ISO holding period requirements described above. If an employee disposes of those shares before the end of the ISO holding period, the employee in most cases has made a disqualifying disposition. Such a disposition results in an increase in the employee's income and a deduction for the employer in the tax year during which the disposition occurs. The increase and deduction are generally based on the spread at the time of exercise. 10 However, if the stock is sold at a price less than the stock FMV on the date of exercise, the amount of compensation income is limited to the excess of the amount realized on the sale over the exercise price. 11 Employers must report compensation income upon a disqualifying disposition, but there is no federal income tax or employment tax withholding requirement on the compensation. 12 For purposes of these rules, dispositions generally include a sale, exchange, gift, or a transfer of legal title. 13 Based on our experience, a significant number of ISO exercises end up being same-day sales of the stock resulting in disqualifying dispositions.

Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

- ⁵ Sections 422(b)(6), 1.422-2(a)(2)(iv).
- ⁶ Sections 422(b)(3), 1.422-2(a)(2)(iii).
- ⁷ Sections 422(b)(5), 1.422-2(a)(2)(v).
- ⁸ Sections 422(b)(4), 1.422-2(e)(1).
- ⁹ Sections 422(c)(1), 1.422-2(e)(2)(iii).
- ¹⁰ Section 421(b).
- ¹¹ Sections 422(c)(2), 1.422-1(b)(2)(i).
- ¹² Section 421(b).
- ¹³ Section 1.424-1(c).

\$100,000 Limitation

There is a limitation on the number of ISOs that can be granted to an employee. The aggregate FMV of stock (determined on the date of grant) as to which incentive stock options are exercisable for the first time in any calendar year (under all plans of the employee's employer) may not exceed \$100,000. To the extent this limitation is exceeded, those options in excess of \$100,000 are treated as NSOs.¹⁴

For example, assume that during 2016 a corporation grants an employee options with a total exercise price of \$125,000 (the exercise price is equal to the stock FMV on the date of grant). Assume further that the options first become vested (no longer subject to a substantial risk of forfeiture) and exercisable at \$75,000 in 2016 and \$50,000 in 2017. In 2018, the employee exercises all the options. In this case, the ISOs would be within the \$100,000 limitation because the FMV of the shares (based on grant value) underlying ISOs first exercisable in 2015 and 2016 did not exceed the \$100,000 limitation during either year. In this example, if all the options were first exercisable in 2015, \$25,000 worth of options would be treated as nonqualified options.

Early Exercises—Exercises before ISOs Vested

Sometimes employers permit employees to exercise options before the options become vested. In these situations, the stock the employees receive on exercise normally retains the same vesting schedule as the options. There are a number of items to consider when employees are permitted to exercise early, before the underlying stock becomes vested.

First, the \$100,000 limitation described above is based on the calendar year during which the options are first exercisable, not the calendar year when the options are first vested. ¹⁵ Using the earlier example in which an employer in 2016 grants ISOs worth \$125,000 that become vested \$75,000 in 2016 and \$50,000 in 2017, if the employer authorizes the employee to exercise all the options early in 2016, the entire \$125,000 counts against the limitation in 2016 even though the underlying stock may not all vest in 2016. Thus, \$25,000 in value would be treated as NSOs

¹⁴ Sections 422(d)(1), 1.422-4(a)(2).

Sections 422(d), 1.422-4. Also see section 83(e)(1), which provides that the section 83 rules (which would include the rules dealing with substantially vesting in stock transferred to service providers) do not apply to ISOs.

and \$100,000 would be treated as ISOs, whether or not the employee actually exercises the ISO in 2016.

An early exercise can also affect the timing of the alternative minimum tax ("AMT") adjustment. For AMT purposes, the section 83 rules apply instead of the normal ISO rules. ¹⁶ Thus, the taxable event for AMT purposes, when an ISO is exercised before the transferred stock becomes vested, is the date the stock becomes vested. For example, assume the exercise price of an ISO and the stock FMV equal \$5 when the ISO is "early exercised." Assume further that the stock FMV when the stock becomes vested is \$8. In this case, the AMT adjustment would equal \$8 minus the \$5 exercise price, for an AMT adjustment of \$3. However, in this case, the employee could make a section 83(b) election, for AMT purposes only, when the stock is transferred on ISO exercise. A section 83(b) election permits an employee to be taxed at transfer of the stock instead of taxed at vesting. Here, if the employee makes the election, the AMT adjustment would be zero–stock FMV of \$5 on the date of exercise is the same as the exercise price.

As noted earlier, the ISO holding period to receive favorable ISO treatment is two years from the date the ISO was granted and one year from the date that stock was transferred on ISO exercised. A transfer occurs whether or not the stock is vested on exercise of the ISO.¹⁷ Thus, on early exercise, the one-year holding period requirement on ISO exercise may be met at the same time the two years from ISO grant requirement is met.

There are special rules that apply to disqualifying dispositions when ISOs are early exercised before the ISOs are vested. ¹⁸ First, at the time of exercise, ISOs are subject to the ISO rules and section 83 does not apply. Thus, the employee cannot make a section 83(b) election at that time for regular tax purposes (although the employee can make such an election for AMT purposes). However, at the time of the disposition, section 83 is used to measure the consequences of the disposition. For example, assume the exercise price of an ISO and the stock FMV equal \$5 when the ISO is early exercised. Assume further that the stock FMV when the stock becomes vested is \$8 and the stock is sold before the ISO holding period is met for a price of \$10. The amount of compensation attributable

¹⁶ Section 56(b)(3).

¹⁷ Sections 1.421-1(g) and 1.422-1(b)(3), Example 2.

¹⁸ Section 1.422-1(b)(3), Example 2.

to the ISO exercise and disqualifying disposition of the stock and the amount deductible by the employer is \$3 (the difference between the stock FMV on the date the stock vested (\$8) and the exercise price (\$5). The additional \$2 gain on sale (\$10 sale price less \$8 stock FMV on vesting) is treated as capital gain.

Post-Termination ISO Exercise Extensions

For an ISO to maintain its qualified status, the Code and regulation require the option to be exercised within three months after an employee terminates employment. Employers frequently include a similar three-month requirement in their option agreements such that the options will terminate three months after an employee terminates employment. An ISO agreement as originally drafted could include a provision that permitted employees to exercise their options post termination for a longer period so long as the extended period did not exceed the statutory 10-year exercise period for an ISO (five years for 10 percent shareholders). However, the ISO would lose its ISO status if the employee did not exercise within three months post termination.

A significant number of employers have extended the period for post-termination ISO exercises beyond the three-month post-termination exercise period. Such an amendment to an outstanding ISO is treated for tax purposes as a modification of the ISO.

A modification, extension, or renewal (a "modification") of an ISO is treated as the grant of a new option. ¹⁹ New grants must meet all the ISO requirements on the date of modification to remain ISOs. For example, if an ISO is in-the-money at the time of extension, it will lose its ISO status because an ISO must be granted with an exercise price not less than the underlying stock FMV on the date of modification—the deemed grant of a new ISO. If the option does not meet the ISO requirements upon modification, the options are treated as NSOs.

A modification is broadly defined to mean any change in an option's terms that gives an employee additional benefits.²⁰ A change to the underlying plan or option that gives an employee additional benefits is considered a

¹⁹ Section 424(b)(1), 1.424-1(e)(2).

²⁰ Section 424(h)(3).

modification even if the employee does not actually benefit from the change.²¹

Employers are permitted to offer employees a choice between an ISO modification and not modifying the ISO. If the modification offer remains outstanding for less than 30 days and employees chose not to modify their ISOs, the ISOs are not treated as modified. However, if the offer to modify the ISOs remains outstanding for 30 days or more or employees chose to modify, the options are treated as modified as of the date the offer to change the terms of the option is made.²²

For example, sometimes employers will offer employees the choice between extending the post-termination exercise period of an outstanding ISO or maintaining the ISO as currently drafted. Assume the offers are outstanding for less than 30 days. If employees choose to maintain the option as drafted, the option maintains its ISO status. If employees chose to have the option extended, the option loses its ISO status and becomes an NSO. As discussed above, ISO status gives the employee capital gain treatment if the ISO holding period is met and avoids income tax withholding and FICA/Medicare taxes on a disqualifying disposition. NSO treatment means all the payroll taxes apply to employees and former employees when the options are exercised.

Employers should consider accounting treatment when extending the post-termination exercise period of an option. A modification of the terms or conditions of an equity-classified option that is in-the-money may be treated as an exchange of the original option for a new option of greater value. Thus, the employer may incur additional compensation cost for financial accounting purposes based on any incremental value increase of the new option. In calculating the incremental compensation cost of a modification, the fair value of the modified option would be compared to the fair value of the original option measured immediately before its terms or conditions were modified. Thus, for example, if the fair value of the modified option is \$15 and the fair value of the original option at the date of the modification is \$10, the incremental compensation cost would be \$5.

²¹ Section 1.424-1(e)(4)(i).

²² Section 1.424-1(e)(4)(iii).

Conclusion

ISOs are a popular incentive option for companies, especially start-up companies. If an ISO meets the holding period requirements, then the employee does not have compensation income, but instead capital gain treatment upon disposition of the stock. However, it is important to remember that there are a variety of requirements that must be satisfied to establish or maintain an ISO plan. When modifying on option or extending an exercise period, the treatment of the option could change from an ISO to an NSO.



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