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IN FOCUS: TAX LAW

Taking Stock of Option Tax Traps

Tax implications of stock options and why granting them at fair market value really matters

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Stock options continue to be one of the primary methods utilized by companies to provide long-term incentive compensation to employees and other service providers. Here we consider the differing tax implications of incentive stock options (ISOs) and nonqualified stock options along with one of the most common factors that can lead to potential issues under Section 409A of the Internal Revenue Code of 1986, as amended (Section 409A): granting an option with an exercise price below the fair market value of the underlying stock on the date of grant.

Nonqualified Stock Options

Any option that is not an ISO is automatically deemed a nonqualified stock option. Nonqualified stock options may be granted to any kind of service provider, not just an employee. Although they are not taxable at grant or when they vest, when the option is exercised the optionee must pay ordinary income tax on the spread between the fair market value of an underlying share on the date of exercise and the original exercise price, and if the optionee is an employee, the company must withhold with respect to this amount as the income is subject to employment taxes. The company may take a deduction when the option is exercised equal to the amount of ordinary income recognized by the optionee. If the company is private, such that there is no market for the stock, and will not permit the optionee to make a "cashless payment" of their withholding tax obligation by holding back such number of shares subject to the option as have a fair market value equal to the amount of the optionee's tax obligation, the optionee will need to obtain liquidity from other sources to pay the tax associated with option exercise.

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Incentive Stock Options

The benefit of holding an ISO, rather than a nonqualified stock option, is that exercise of an ISO does not give rise to compensation income. In order for an option to qualify as an ISO, certain statutory requirements must be met. Some of these requirements are also commonly seen in the terms of a nonqualified option award, such as the requirements that the option (1) have a term of not more than 10 years and (2) not be transferable other than by will or the laws of descent and distribution. However, certain requirements are significantly more restrictive:

1. the optionee must be an employee of either the corporation issuing the option or a parent or subsidiary of such corporation and must remain an employee continuously from the date of grant to the date three months before exercising the ISO;
2. the aggregate fair market value of the stock with respect to which the ISOs held by an employee are exercisable for the first time during any calendar year must not exceed $100,000, measured as of the date of grant; and
3. the exercise price must be at least equal to the fair market value of the underlying stock on the date of grant, or if the optionee holds more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or its parent or subsidiaries, the exercise price of the ISOs must be at least 110 percent of the fair market value of the underlying stock on the date of grant and the option term must be no longer than five years.

Any options granted that do not satisfy all of these requirements will automatically become nonqualified options such that, for example, if an employee received options with a grant date value of $500,000 vesting ratably over four years at a rate of $125,000 per year, the first $100,000 of those options vesting each year would be ISOs, assuming all other requirements were met, and the remaining $25,000 would be nonqualified options.

If all statutory requirements are met, ISOs are not subject to income tax at grant, vesting or exercise, although the spread between the exercise price and the fair market value of the underlying stock at exercise is taken into account in computing the federal

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alternative minimum tax. Additionally, the gain from the sale of the stock purchased pursuant to the exercise of the options will qualify as long-term capital gain if the sale occurs more than two years after the date the option is granted and one year after the option is exercised.

Although ISOs therefore may provide significant tax benefits for the optionee, the company may not take a deduction when an ISO is exercised. However, if the optionee sells the underlying stock at a profit before each of the periods described above have lapsed, this is deemed a disqualifying disposition, and the employee must pay tax on the spread at exercise as compensation income. The company may then take a deduction in the year of this disqualifying disposition equal to the employee's amount of compensation income. Any profit in excess of the spread at exercise due to an increase in stock price between the date of exercise and the date of sale is treated as capital gain. If the optionee sells the shares at a loss, it is a capital loss, and the optionee does not have any compensation income regardless of the spread at exercise. Additionally, if an ISO is cancelled in exchange for a cash payment, as may be the case in a corporate transaction in which the company is undergoing a merger or acquisition, this payment is treated as compensation income and the company may take a deduction with respect to the income amount.

Section 409A

Section 409A regulates deferred compensation – that is, amounts earned in one year that are payable in a future year – and may apply to a broad range of arrangements from severance payments to bonus plans. An ISO does not constitute a deferral of compensation under Section 409A and so is considered exempt. A nonqualified stock option is also exempt from the perils of Section 409A if it satisfies certain requirements, which include the following:

1. the option is to purchase service recipient stock, which broadly speaking means common stock without a distribution preference of a corporation for which the optionee performs direct services or that has a direct or indirect controlling interest in the stock of the optionee's employer, determined as of the date of grant; and
2. the exercise price is equal to or greater than the fair market value of the underlying stock on the date of grant.

Often during the diligence process conducted in connection with the purchase of a company or making a minority investment, it will be determined that a previously granted option was in fact granted with an exercise price below the fair market value of the underlying stock on the date of grant. As a result, in general, the option will not be exempt from, Section 409A.

A traditionally structured option will not comply with Section 409A because a key feature and advantage of an option is that it gives the optionee broad discretion to elect when to exercise the option and thus to choose the tax year in which income is received. For example, a nonqualified option may be granted in 2015 and become fully vested by 2019 but remain exercisable at any time the optionee elects prior to 2025. As a result, if the exercise price cannot be corrected, as described below, the entire amount of the spread between the fair market value of an underlying share on the date the option becomes vested and the original exercise price must be included in income in the year of vesting and will be subject to a 20 percent additional federal tax. During each subsequent year prior to exercise, any increase in the spread must be included in income and will also be subject to a 20 percent additional federal tax. As such, failure to comply with Section 409A causes taxation to accelerate from the date of exercise to the date of vesting, and if this noncompliance is not discovered until a later year, such that the spread is not included in income in the year of vesting, the optionee may also be subject to premium tax penalties and interest, and the employer would also likely be subject to regulatory penalties (of a smaller magnitude) for inaccurate tax withholding and reporting. In order to avoid this outcome and ensure an option remains exempt from Section 409A, it is necessary to consider the meaning of both "date of grant" and "fair market value" under the Section 409A regulations.

Date of Grant

Under the Section 409A regulations, the date of grant can be no earlier than the date on which the corporation completes the corporate action necessary to create a legally binding right. This requires the following key terms to be fixed and determinable: (1) the maximum number of shares that can be purchased pursuant to the option, (2) the minimum exercise price, (3) the class of underlying stock and (4) the recipient of the option. If the written consent of the board of directors or other corporate action indicates that the intention is to make an immediate grant, the grant date will be the date of such consent or other corporate action, and if it specifies a future grant date, that specified date will be the grant date. However, if there is an unreasonable delay in notifying the optionee of the grant, the date of grant may be deemed to be the date of communication with the optionee, by which time the fair market value of the underlying stock may have increased. As a result, companies should ensure there is a process in place, whether email notification or other simultaneous communication, to ensure that optionee communication is closely coordinated with the date the grant approved by the board of directors.

Fair Market Value for Publicly Traded Stock

A public company may use any of the following prices as the fair market value of the stock underlying a particular option grant:

1. the last sale price before the grant or the first sale price after the grant;
2. the closing price on either the trading day before the grant or the trading day of the grant;
3. the mean of the high and low prices on the trading day before the grant or the trading day of the grant;
4. an average selling price during a specified period provided that (a) this period does not extend more than 30 days before or after the date of grant and (b) the optionee and the number of options is identified prior to the beginning of this period; or
5. any other reasonable method of determining fair market value, provided that it uses actual transactions in the stock as reported on the applicable securities market.

Fair Market Value for Private Company Stock

For a private company, the Section 409A regulations require only that fair market value be determined by the reasonable application of a reasonable valuation method. Although the determination of what is reasonable will depend on the facts and circumstances, a valuation method is not reasonable if it does not take into account all material information available prior to the date of grant, and the regulations state that the factors to be considered include (1) the value of tangible and intangible assets of the company, (2) the present value of anticipated future cash flows of the company, (3) the market value of stock or equity interests in a substantially similar corporation, which is either tradable on an

established market or was recently sold in an arm's length transaction, (4) recent arm's length transactions, (5) control premiums and (6) discounts for lack of marketability.

Although a third-party independent appraisal is not required in order for a valuation to be reasonable, if one is completed no more than 12 months prior to the date of grant it will be presumed to be reasonable, rebuttable only by showing that the valuation is grossly unreasonable. Companies should be wary of granting options during the period in which such an appraisal is being conducted, which can often take several months, as the valuation may determine the stock price to be higher than the exercise price set for those interim option grants. For example, if a company commissions a new appraisal in September, grants options in October with an exercise price of $15.50 based on a prior appraisal, and then in November receives the new appraisal current as of September showing a fair market value of $28.50, it would be difficult to maintain that those October grants were in fact made at fair market value even though they were based on the most recent valuation available as of the date of grant.

Remedy Opportunities

Where an option is granted with an exercise price below fair market value, this violation may be corrected without penalty by increasing the exercise price to at least the fair market value on the date of grant either:

1. in the year of grant; or
2. if the optionee is not a senior executive with policy-making authority, in the year following the year of grant, but in each case no event later than the date the option is exercised.

As the correction window permitted under Section 409A is relatively brief, it is crucial that a company take the necessary steps each time an option is granted to ensure that the fair market value of the underlying stock is correctly determined, both to ensure ISOs are not disqualified into nonqualified options and that nonqualified options do not lose their exemption from Section 409A and trigger significant penalty taxes.