

Unexpected Risks of Early Exercise Incentive Stock Options

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Canadian companies and their outside counsel occasionally ask about the ability to grant *early exercise* incentive stock options (“ISOs”) to limit the impact of the U.S. alternative minimum tax (“AMT”) to their U.S. employees. However, due to fairly counterintuitive U.S. federal tax regulations, structuring options in this manner may expose optionees to negative tax consequences in the event of a disqualifying disposition (defined below). This post reviews the tax effects of early exercise ISOs and compares the tax results to alternative structures.

Early Exercise ISO Tax Consequences

With any early exercise option, the optionee is permitted to initially exercise their entire stock option by paying the full option exercise price, but will receive back restricted stock with the same vesting schedule as the original option. Employees will usually file a Section 83(b) election as permitted within 30 days following the transfer of the restricted stock. In 2004, final ISO regulations clarified that Section 83(b) elections filed on restricted shares acquired via early exercise ISOs are only effective for AMT purposes and not for ordinary compensation tax purposes. In the best case where both ISO holding periods are met (the shares acquired via ISO are held at least two years from the date of grant and at least one year from the date of exercise, prior to sale), the entire spread between the sale price and the exercise price paid will be taxed as long-term capital gain. However, if either holding period is not met, a “disqualifying disposition” occurs. Assuming that an 83(b) election was timely filed within 30 days following exercise, then upon a disqualifying disposition, the difference between the fair market value of the shares *on the date the underlying restricted stock vests* less the exercise price paid for the shares is compensation income that will be reported on the employee’s Form W-2 in the year of sale (or if less, the amount realized in the sale less the exercise price).[1] In addition, the capital gains holding period will only begin on the date the underlying restricted stock vests.[2] To the extent the stock price increased or decreased from the date of restricted stock vesting, such change will be short-term or long-term capital gain or loss, as applicable.

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This tax result means that early exercise ISOs become risky to an optionee in the event of a disqualifying disposition. While reducing AMT income is a positive result, a disqualifying disposition results in a potentially large amount of compensation income and/or short-term capital gain. The optionee often has little control over whether a disqualifying disposition will occur, such as if all shares are sold in connection with an acquisition of the issuer or if the optionee's shares are repurchased following termination from employment.

Early Exercise NSO Tax Consequences

As compared to an ISO, the exercise of a non-qualified stock option ("NSO") is not a preference item for AMT purposes. If an optionee early exercises a NSO, an 83(b) election will be respected for compensation purposes and the optionee will only recognize compensation income equal to the fair market value of the shares on the date of exercise less the option's exercise price. This income will be subject to applicable withholding for federal and state payroll taxes, including FICA. However, if the option is early exercised shortly following the option grant date, as is often the case, there is typically minimal (or zero) spread to recognize as compensation up front. The 83(b) election also starts the capital gains holding period. Thereafter, the vesting of the underlying restricted stock received upon the early exercise will not result in any further compensation income to the optionee. Upon disposition of the stock, capital gain or loss will be recognized in the year of sale, which will be long-term if the stock is held at least one year from the date of early exercise.

Therefore, in contrast to early exercise ISOs, early exercise NSOs can reduce the exposure to gain being characterized as short-term capital gain to the one year after the early exercise, provided the 83(b) election is timely filed. In addition, by exercising and filing an 83(b) election shortly following grant, recognition of compensation income may be limited or eliminated. Early exercise ISOs have an overhang for up to two years following the date of grant where a disqualifying disposition could result in both compensation income and short-term capital gain recognition. For these reasons, as illustrated in the examples below, we find early exercise NSOs to be preferable to early exercise ISOs in most cases. This is especially true with respect to companies where (i) there is a possibility of acquisition within two years following the date of grant, (ii) the optionees have sufficient capital to early exercise the awards, and (iii) the optionees see a meaningful upside for the company at the time of early exercise (or the amount needed to early exercise is relatively small).

Example 1

A startup company grants early exercise ISOs for 1000 shares to an employee at \$0.05 per share on June 1, 2017, subject to a vesting schedule where 50% vests on June 1, 2018, and the remaining 50% vests on June 1, 2019. Participant early exercises on June 5, 2017 while shares are still worth \$0.05 per share and files an 83(b) election recognizing \$0 in income, which is effective only for AMT purposes. Upon exercise, the participant receives restricted shares with the same two-year vesting schedule. When 50% of the shares vest on June 1, 2018, the fair market value has risen to \$5 per share.

On March 1, 2019, the company is sold via a stock purchase agreement for \$10 per share. All unvested equity awards are accelerated and the shares held by the participant are sold in the deal, resulting in a disqualifying disposition, as both ISO holding periods were not met.

- Participant recognizes compensation income equal to the spread between FMV on the date the restricted stock vested less the exercise price paid: For the 500 shares that vested on June 1, 2018, $500 \times \$ (5.00 - .05) = \$2,475$. For the 500 shares that vested in connection with the March 1, 2019, transaction, $500 \times \$ (10.00 - .05) = \$4,975$. Total compensation income recognized due to disqualifying disposition is $\$2,475 + \$4,975$, or $\$7,450$.
- The capital gains holding period begins on the date of restricted stock vesting. Because both tranches of restricted stock vested less than a year prior to the March 1, 2019, transaction, the \$10,000 received in the stock sale less (i) \$7,450 previously recognized as compensation income and (ii) \$50 in total exercise price paid, or \$2,500, is short-term capital gain.

Example 2

Assume the same facts as Example 1, but with an early exercise NSO instead:

- The 83(b) election on June 5, 2017, results in \$0 in compensation recognition and also begins the capital gains holding period.
- No compensation income is recognized with the vesting of the underlying restricted shares, as there is no disqualifying disposition concept applicable, and the 83(b) election was effective for compensation tax purposes.
- Upon the sale of the company on March 1, 2019, the entire \$10,000 received minus the \$50 amount paid in exercise price, or \$9,950, will be recognized as long-term capital gain.

Example 3

Assume the same facts as Example 1, but with a regular ISO grant (without the early exercise feature) that is exercised immediately prior to the March 1, 2019, transaction:

- No compensation income recognized at the time of exercise under the ISO rules.
- The March 1, 2019, sale of the shares will be a disqualifying distribution, characterizing the full \$10,000 received minus the \$50 amount paid in exercise price, or \$9,950, as compensation income.

[1] U.S. Treas. Reg. Sec. 1.422-1(b), Ex. 2.

[2] Id.