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U.S. INCOME

Statutory Stock Options

by

Alan Tawshunsky, Esq.

Alan Tawshunsky, B.A., Queens College, *magna cum laude;* J.D., Georgetown University Law Center, *magna cum laude;* co-chair, Employee Benefits Committee of ABA Business Law Section; member, New York and District of Columbia Bars; principal, Tawshunsky Law Firm PLLC; former Deputy Associate Chief Counsel for Employee Benefits, Internal Revenue Service.

This Portfolio revises and supersedes previous versions of 381-5th T.M., *Statutory Stock Options*.

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PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Statutory Stock Options*, No. 381-5th, details the structure of, and the tax rules regarding, incentive stock options and employee stock purchase plans. Both types of plans provide for the deferral of the recognition of taxable income upon receipt of stock pursuant to these plans if certain requirements are satisfied.

This Portfolio outlines the statutory requirements for incentive stock option plans and employee stock purchase plans, and also describes optional plan provisions. The tax consequences of these plans to the employer and employees are reviewed. In addition, this Portfolio compares incentive stock options with nonqualified stock options. For an analysis of rules governing nonqualified stock options, see 383 T.M., *Nonstatutory Stock Options.*

Many of the topics discussed herein are considered in greater detail in other Tax Management Portfolios. Tax Management Portfolios on related topics include: 383 T.M., *Nonstatutory Stock Options*; 384 T.M., *Restricted Property — Section 83*; 385 T.M., *Deferred Compensation Arrangements*; 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation*; and 322 T.M., *Global Share Plans: Issues for Multinational Employers*.

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DETAILED ANALYSIS

I. Introduction

A. Overview

This Portfolio examines the qualification and taxation of two types of employee stock options that receive special treatment under the Code:[1]

- incentive stock options ("ISO" or "ISOs"); and
- options granted under employee stock purchase plans.

In this Part I and in Part II, below, references to "options" will refer both to ISOs and to compensatory options that do not qualify as ISOs (often referred to as "nonqualified" or "nonstatutory" stock options ("NSO" or "NSOs")). Options granted under employee stock purchase plans are discussed in Part III, below.[2]

Generally, ordinary income is not recognized on either the grant or the exercise of an ISO. If the stock received upon the exercise of an ISO is held for the applicable holding period prescribed under the Code, the stock will be treated as a capital asset. Any gain recognized following such exercise will be taxed as long-term capital gain[3] upon a subsequent sale or disposition.

B. What Is an Option?

An option gives the person granted the option (the grantee or optionee) a legally enforceable right to purchase property from the option grantor (generally the employer for purposes of this Portfolio) during a specified period at a specified price.[4] If, however, the optionee does not wish to exercise the option, the grantor has no right to require the optionee to exercise the option and purchase the property.[5] In the case of an ISO (or NSO), the optionee can capture value by exercising the option when the value of the stock to which the option is subject is greater than the exercise price of the option. Conversely, the optionee generally will not want to exercise the option when the value of the stock subject to the option is below the exercise price. An option can provide the optionee with the right to exercise the option immediately. When the option is provided as compensation, however, the right to exercise the option is often contingent upon satisfying a service-based and/or performance-based vesting schedule.

C. Uses of Corporation Stock as a Compensation Device

By providing part of an employee's compensation in the form of options to purchase stock in the employer, instead of cash, an employer can both provide a direct incentive for the employee to enhance stockholder value, and conserve available cash to use in growing the corporation. An option granted under a compensatory stock option plan gives the employee receiving the option the opportunity to share in the appreciation in the value of the employer's stock before the option is exercised without assuming the risk of a decline in value of the stock. Certain tax-qualified retirement plans described in §401(a), such as employee stock ownership plans (ESOPs) and profit-sharing plans that invest in employer stock, also give employees an opportunity to share in the potential growth of their employer's stock, but are less flexible than stock options. ESOPs and profit-sharing plans must meet the coverage, nondiscrimination, distribution, and other qualification requirements imposed upon tax-qualified retirement plans by the Code, which makes it difficult to tailor those plans to benefit select groups of employees, particularly highly compensated employees.

By contrast, compensatory stock option plans generally permit the employer, if it chooses, to focus the plan's benefits only on those employees whose efforts may directly affect the stock's value.[6] Additionally, the terms of an option under a

[1] Unless otherwise indicated, all section ("§") references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder.

[2] Equity incentive awards may be issued by various forms of legal entities, including corporations, partnerships, limited liability companies, and joint ventures. This Portfolio focuses principally on tax-favored incentive stock options issued by corporations, and is not intended to cover or provide a discussion of the tax issues relating to equity awards issued by non-corporate entities and partnerships, including joint ventures and limited liability companies taxed as partnerships.

[3] When this Portfolio refers to "capital gain or loss" without specifying whether the gain or loss is "long-term" or "short-term," it is intended that the capital gain or loss might be either long-term or short-term depending on the circumstances. When this Portfolio refers to "long-term capital gain or loss" or "short-term capital gain or loss," it assumes the applicable holding period is more than one year for long-term capital gain and one year or less for short-term capital gain, as provided in §1222. Furthermore, this Portfolio assumes that the general rule found in Rev. Rul. 66-7 and Rev. Rul. 66-5, for determining holding periods, applies for all purposes relating to compensatory stock options. See discussion in II.A.1.c., and II.C.7., below.

[4] Reg. §1.421-1(a)(1).

[5] Reg. §1.421-1(a)(1).

[6] While employers have great flexibility to restrict eligibility for stock options under most plans, there are exceptions. As discussed in section III, below, under an employee stock purchase plan, all employees of the designated participating corporations must be eligible to participate in the plan, except those categories of employees specifically permitted to be excluded under §423. Also, §13603 of the TCJA (Pub. L. No. 115-97) added §83(i), effective for stock attributable to options exercised, or restricted stock units (RSUs) settled, after December 31, 2017. Pub. L. No. 115-97, §13603(f). Section 83(i) allows employees of certain privately held employers to defer tax upon exercise of stock options (or settlement of RSUs) granted pursuant to plans that meet certain requirements. Among the requirements of §83(i) is that options (or RSUs) be granted to at least 80% of the employees who provide services to the employer in the United States. §83(i)(2)(C)(II). For initial guidance on the application of §83(i), see Notice 2018-97 (explaining the 80% availability requirement, withholding obligations, and the ability of employers to opt out of permitting employees to elect deferred tax treatment under §83(i)). The Treasury and IRS anticipate that the guidance set forth in Notice 2018-97 will be incorporated into future regulations that, with respect to issues addressed therein, will apply to any taxable year ending on or after December 7, 2018. Any future guidance, including regulations that address the issues in Notice 2018-97 will apply on a prospective basis only. For further discussion of §83(i), *see* 384 T.M., *Restricted Property — Section 83* and 385 T.M., *Deferred Compensation Arrangements.* Section 83(i) is effective for stock attributable to options exercised, or restricted stock units settled, after December 31, 2017. Pub. L. No. 115-97, §13603(f). For an explanation of §83(i), see Alan Tawshunsky,

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compensatory stock option plan may also contain provisions to assist an employee in financing the exercise price of the option, such as the use of employer stock to exercise the option, broker assisted "same-day sale" exercise programs (in the case of options for publicly traded stock), employee loan programs, or the use of a net exercise approach.

Moreover, the restrictions on permissible distributions from tax-qualified retirement plans often prevent the employees participating in those plans from realizing any immediate benefit from appreciation in employer stock, because distributions from tax-qualified profit-sharing plans and ESOPs generally cannot be made until retirement, disability, death or other termination of employment, or attainment of age 59½. By contrast, employees receiving stock options can realize the gains on the options while they are still employed (and before age 59½). Most ESOPs and profit-sharing plans are also subject to the Employee Retirement Income Security Act of 1974 (ERISA),[7] while ISOs are generally exempt from ERISA.

A Closer Look at Tax-Deferred Equity Compensation Under New §83(i), 46 Compensation Plan. J. 66 (Apr. 6, 2018).

[7] Pub. L. No. 93-406, 88 Stat. 829 (1974), as codified at 29 U.S.C. §1001–§1461.

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II. Incentive Stock Options

A. Summary of Tax Treatment of Optionee and Employer

Part II.A summarizes the tax treatment of ISOs. Parts II.B through II.G provide a more detailed explanation of the requirements for, and tax treatment of, ISOs. Part II.H provides a comparison of ISOs with NSOs. This Part II concludes with brief overviews of securities law (Part II.I), accounting (Part II.J), and international (Part II.K) issues related to ISOs.

The summary of the tax treatment associated with ISOs in this Part II.A should be read in conjunction with the more complete discussions regarding the taxation of the employee in II.C., and the impact on the employer in II.D., below. The tax consequences discussed in this Portfolio generally are limited to U.S. federal income tax treatment.[8] The discussion assumes (except where specifically noted) that the corporation granting the option is the employer of the employee and is a domestic corporation,[9] and that the employee is a U.S. taxpayer who is employed full time in the United States.

1. Optionee Tax Treatment

a. Grant of an ISO

The optionee has no tax consequences from the grant of an ISO, regardless of whether any portion of the ISO is vested upon grant.

b. Exercise of an ISO

The optionee has no regular income tax consequences from the exercise of an ISO.[10] However, the amount by which the fair market value of the stock received upon the exercise exceeds the exercise price is generally a tax preference adjustment for purposes of the alternative minimum tax calculation.[11] If the optionee incurs alternative minimum tax as a result of the exercise of an ISO, §53 generally will result in an alternative minimum tax credit carryover for use in future years. See II.C.5., and II.C.8., below, for more detail regarding the tax consequences to the optionee on exercise of an ISO and the alternative minimum tax.

c. Sales of Shares Acquired upon the Exercise of an ISO

The tax consequences to the optionee from the sale or other disposition of stock acquired upon the exercise of an ISO are complex. If the optionee incurs a gain on the sale, the character of the gain depends upon both the length of time from the grant of the ISO to the date of sale and the length of time from the exercise of the ISO until the date of sale. Losses are generally capital losses, with the holding period generally commencing the day after the date of exercise.[12] See II.C.7., below, for more detail regarding the tax consequences to the optionee from a sale or other disposition of stock acquired upon the exercise of an ISO.

d. ISOs and §409A

Section 409A provides special rules governing arrangements that provide for a "deferral of compensation."[13] The grant of an ISO, however, is not a "deferral of compensation" for purposes of §409A.[14] Therefore, the grant or vesting of an ISO is not subject to the rule in §409A(a)(1)(A)(i) that requires income recognition upon vesting of deferred compensation that fails to comply with §409A. If an ISO is modified, however, it may be treated as if it were an NSO from the date of its grant and may, therefore, be subject to income recognition on vesting under §409A(a)(1)(A)(i).[15]

2. Employer Tax Treatment

The employer has no tax consequences, including no entitlement to a deduction, from the grant or exercise of an ISO. The employer also has no tax consequences from the sale or other disposition of stock acquired through the exercise of an ISO to the extent the optionee recognizes a capital gain or loss. If the optionee recognizes ordinary income on a sale or other disposition of the shares acquired upon the exercise of an ISO, the employer is generally entitled to a §162 compensation deduction equal to the amount of such ordinary income recognized by the optionee.[16]

Unless an exception applies, however, §162(m) generally denies a deduction for compensation in excess of $1 million paid to a "covered employee" by a publicly traded corporation. Under §162(m) prior to amendment by the Tax Cuts and Jobs Act of 2017,[17] if an employee recognized ordinary income upon the exercise of an option and the employer followed the procedural requirements for performance-based compensation spec-

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[8] While the tax treatment of options by individual states mirrors the federal tax treatment in many instances, not all states follow the federal tax rules. *See, e.g.*, Cal. Rev. & Tax. Code §17502; John Barry, No. 250920 (Cal. State Bd. of Equal. Jan. 25, 2005) (California treatment of disqualifying disposition); *Michaelsen v. N.Y. State Tax Comm'n*, 67 N.Y.2d 579, 496 N.E.2d 674 (1986); *In re Stuckless*, No. 819319 (N.Y. Tax App. Trib., Aug. 17, 2006), *rev'g*, No. 819319 (N.Y. Dept. of Taxn. and Fin. Dec. 15, 2005) and *withdrawing* No. 819319 (N.Y. Tax App. Trib. May 12, 2005) (income from stock options that were granted while taxpayer was resident of New York and exercised in tax year when taxpayer was not resident of New York was not taxable in New York); New York TSB-M-06(7)I (Oct. 12, 2006) (guidance for determining taxable income related to option, restricted stock, or stock appreciation in light of *Stuckless*). *See also* N.Y. Dep't of Tax'n and Fin., *New York State Tax Treatment of Stock Options, Restricted Stock, and Stock Appreciation Rights Received by Nonresidents and Part-Year Residents*, TSB-M-07(7)I (Oct. 4, 2007), *available at* https://www.tax.ny.gov. For further information see, 366 T.M., *State Taxation of Compensation and Benefits.*

[9] "Domestic" is defined in §7701(a)(4). A foreign corporation is not precluded from issuing ISOs if it either is a "per se" corporation or, if not a per se corporation, it has not turned itself into a pass-through entity under the check-the-box regulations. *See* Reg. §1.421-1(i)(1); §301.7701-2(b), §301.7701-3.

[10] §421(a)(1).

[11] §56(b)(3). Note, however, that there may be a modification to this rule in the event of a disqualifying disposition in the same calendar year as exercise.

[12] *See* Rev. Rul. 66-7, Rev. Rul. 66-5. Note that the method of computing holding periods under §1223(5) and Reg. §1.1223-1(f) appears to conflict with that contained in Rev. Rul. 66-7 and Rev. Rul. 66-5. This Portfolio applies the convention set forth in Rev. Rul. 66-7 and Rev. Rul. 66-5.

[13] §409A(a)(1)(A)(i).

[14] Reg. §1.409A-1(b)(5)(ii).

[15] Reg. §1.409A-1(b)(5)(ii). See discussion in II.G.1., below.

[16] §421(b). *See* Reg. §1.421-2(b)(1)(i) (stipulating that the requirements of Reg. §1.83-6(a) must be satisfied in order for the deduction to be allowable). See discussion in II.D.4.e., below.

[17] Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 (Dec. 22, 2017), hereinafter the TCJA.

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ified in IRS regulations,[18] the performance-based compensation exception generally applied, thereby allowing the employer a deduction with respect to the option exercise, even for compensation subject to §162(m).[19] The TCJA (Pub. L. No. 115-97) amended §162(m) to remove the exception for performance-based compensation.[20]

Section 13601(e) of the TCJA also amended the definition of "covered employee" and various other provisions of §162(m).[21] Compensation provided pursuant to a written binding contract, which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date, remains subject to the prior version of §162(m), including the performance-based compensation exception.[22] Conversely, if a covered employee recognizes ordinary income on the exercise of a stock option, and the amendments made by the TCJA apply to the exercise (and the legacy treatment does not apply), then, unless the covered employee's total compensation is below $1 million or an exception applies, a publicly traded employer's deduction with respect to that exercise may be limited or eliminated by §162(m).

A full discussion of §162(m), and the amendments to §162(m) made by the TCJA, is beyond the scope of this Portfolio. Except as specifically noted, references throughout this Portfolio to the deduction for the employer merely take into consideration the deductions permitted by §83(h), §162 (other than §162(m)) and §421(b) and this Portfolio does not address deduction disallowance provisions such as §162(m) or requirements to capitalize, rather than deduct, compensation. For detailed discussions of these topics, see 390 T.M., *Reasonable Compensation.*

Effective January 1, 2023, the Inflation Reduction Act imposes a 1% excise tax on the fair market value of stock of a "covered corporation" that is repurchased by the corporation.[23] A "covered corporation" is any domestic corporation with stock traded on an established securities market.[24] In determining the amount of the excise tax, the fair market value of stock repurchased by the corporation during a year is reduced by the fair market value of stock issued by the corporation during that year, including stock issued or provided to employees, whether through exercise of an option or otherwise.[25]

Note: Accordingly, if a covered corporation repurchases stock during a year, the exercise of ISOs and NSOs by employees during that year will generally reduce the amount of the excise tax owed with respect to the repurchases.

The remainder of this Part II contains a more detailed discussion of the requirements for ISOs, the tax treatment of optionees and employers, and the treatment of ISOs in special situations such as a merger of the company or the death of the optionee, as well as a brief overview of some additional issues.

B. Requirements for ISOs

For a stock option to qualify as an ISO, the option and optionee must meet certain requirements when the option is granted.[26] In order to receive the favorable tax treatment discussed in the previous section, additional requirements must be met during the period the option is held by the optionee before it is exercised and during the period between exercise and sale.[27] Special rules apply in determining the fair market value of the stock subject to the ISO, and to changes to the ISO after it has been granted, a substitution or assumption of an ISO, or ISOs granted to a 10% owner. See II.B.3., below, for a discussion of the special rules.

1. Date of Grant Requirements

a. Employee Status Requirement

On the date the option is granted, the optionee must be an employee of a corporation and the option must be granted by the employer corporation or a parent or subsidiary of the employer corporation.[28] A corporation qualifies as a parent or subsidiary of the employer corporation if it satisfies the tests in §424(e) or §424(f), which require ownership of stock representing 50% or more of the combined voting power of all classes of stock. A parent need not be the direct owner of the employer corporation, and a subsidiary need not be the direct subsidiary of the employer corporation, as long as they are connected to the employer corporation by an unbroken chain of corporations, each of which owns 50% of the combined voting power in all classes of stock of one of the other employers in the chain.[29]

Whether an employment relationship exists is generally determined by the withholding tax rules of §3401(c).[30] Provided that a bona fide employment relationship exists, a part-time employee may receive an ISO. While no minimum hours of service requirement applies in determining whether a bona fide

[18] Reg. §1.162-27(e).

[19] Reg. §1.162-27(e).

[20] Pub. L. No. 115-97, §13601(a).

[21] Pub. L. No. 115-97, §13601(e)(2). The amendments made by §13601 of the TCJA are generally effective for taxable years of the employer beginning after December 31, 2017. The IRS issued proposed regulations under §162(m) in 2019 ("Proposed Regulations"). REG-122180-18, 84 Fed. Reg. 70,356 (Dec. 20, 2019) and Final Regulations in 2020 ("Final Regulations"), 85 Fed. Reg. 86,481 (Dec. 30, 2020). The 2020 Final Regulations are applicable to taxable years beginning on or after December 30, 2020, with exceptions for certain special applicability dates, although taxpayers may choose to apply the Final Regulations to a taxable year beginning on or after December 31, 2017. Soon after the enactment of the TCJA, the IRS provided interim guidance on §162(m). *See* Notice 2018-68. However, the preamble to the 2019 Proposed Regulations states that, except as provided by the special applicability dates, taxpayers may no longer rely on the interim guidance of Notice 2018-68 for taxable years ending on or after December 20, 2019. 84 Fed. Reg. at 70,370.

[22] Pub. L. No. 115-97, §13601(e)(2). The IRS released guidance on the application of the legacy treatment, including the definitions of a "binding contract" and a "material modification." *See* Reg.§1.162-33, added by T.D. 9932, 85 Fed. Reg. 86,481 (Dec. 30, 2020), generally effective on or after December 30, 2020, with the option for earlier applicability with respect to taxable years beginning after December 31, 2017.

[23] §4501, as added by the Inflation Reduction Act, Pub. L. No. 117-169, §10201, effective for taxable years beginning after December 31, 2022. For further discussion of this excise tax, including the reporting and payment rules, see 767 T.M., *Redemptions.*

[24] §4501(b), as added by Pub. L. No. 117-169. Certain acquisitions of stock of the covered corporation by a "specified affiliate" of the covered corporation are treated as repurchases by the covered corporation.

[25] §4501(c)(3), as added by Pub. L. No. 117-169.

[26] Reg. §1.422-2(a)(1), §1.422-2(a)(2).

[27] Reg. §1.422-1.

[28] §422(b).

[29] §424(e), §424(f); Reg. §1.424-1(f).

[30] Reg. §1.421-1(h)(1). *See also Ellison v. Commissioner*, 55 T.C. 142 (1970), *acq.*, 1971-1 C.B. 2. For a detailed discussion of employment status determinations, see 391 T.M., *Employment Status — Employee v. Independent Contractor.*

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employment relationship exists, if the number of hours of service performed by an employee is low, the IRS may question whether a bona fide employment relationship is present. The employment relationship, i.e., the actual rendering of services, must have commenced by the date of grant of the option. The acceptance of an offer of employment is not sufficient if the optionee has not commenced actual employment. A potential employee can be granted an option conditioned on the commencement of employment; in such case, the option is deemed granted on the date employment commences, and the ISO requirements relating to the date of grant are tested as of the date employment commences.[31]

If an option is assumed or a new option is substituted in its place, then at the time of such substitution or assumption, the optionee must be an employee (or a former employee within the three-month period following termination of the employment relationship) of the corporation substituting or assuming the option or a parent or subsidiary of such corporation.[32] In addition, the rules with respect to a qualifying transfer pursuant to the exercise of the option[33] generally only apply if the optionee is, at all times during the period beginning with the date of grant of such option and ending on the day three months before the date of such exercise, an employee of:

- the corporation granting such option;
- the corporation substituting or assuming a stock option; or
- a parent or subsidiary of either such corporation.

For these purposes, the employment relationship is treated as continuing intact while the individual is on military leave, sick leave or other bona fide leave of absence (such as temporary employment by the government) if the period of such leave does not exceed three months, or if longer, so long as the individual's right to reemployment with the corporation is provided either by statute or by contract. If the period of leave exceeds three months and the individual's right to reemployment is not provided by statute or by contract, the employment relationship is deemed to terminate on the first day immediately following such three-month period. Thus, if the option is not exercised before such deemed termination of employment, the nonrecognition provision of Reg. §1.421-2(a) applies to the transfer of a share pursuant to an exercise of the option only if the exercise occurs within three months from the date the employment relationship is deemed terminated.[34]

Example: If an optionee is on sick leave for a year, and has no right to reemployment by statute or contract, the option must be exercised no later than six months after the optionee begins sick leave (the employment relationship is deemed terminated three months after the start of sick leave and the optionee must exercise the option within three months of that deemed termination).

b. ISO Plan Requirements

The option must be granted pursuant to a plan meeting the following requirements of §422(b):

(1) *Written or electronic document.* The plan must be contained in a written document, either on paper or in electronic form, that meets the requirements of §422(b). The writing or electronic form must be adequate to establish the terms of the plan.[35]

(2) *Shares issuable.* The maximum aggregate number of shares that may be issued under the plan through ISOs must be fixed when the plan is adopted (except for adjustments due to stock splits and similar transactions). A plan that provides that the number of shares that may be issued under ISOs may not exceed a stated percentage of the shares outstanding at the time of each offering or grant does not satisfy this requirement. The maximum aggregate number of shares that may be issued under ISOs pursuant to the plan, however, may be stated in terms of a percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. Furthermore, the plan may specify that the maximum aggregate number of shares available for grant under the plan may increase annually by a specified percentage of the authorized, issued, or outstanding shares at the date of the adoption of the plan. A plan that provides that the maximum aggregate number of shares that may be issued pursuant to ISOs under the plan may change based on any other specified circumstances satisfies these requirements only if the stockholders approve an immediately determinable maximum aggregate number of shares that "may be issued under the plan in any event."[36]

If NSOs or other stock-based awards may be granted, the plan may separately designate terms for each type of option and other stock-based award and designate the maximum number of shares that may be issued under such option or other stock-based award. Unless otherwise specified, all terms of the plan apply to all options and other stock-based awards that may be granted under the plan.[37]

A plan may provide that shares purchasable under the plan pursuant to ISOs may be supplied to the plan through acquisitions of stock on the open market, shares purchased

[31] Reg. §1.421-1(c)(2).

[32] Reg. §1.421-1(h)(1). Although the regulations frequently use the term "related corporation," while the Code uses the more precise term "a parent or subsidiary corporation of such corporation" (*see, e.g.*, §422(a)(2)), the former phrase is used only for brevity, and the regulations make clear that it has the same restricted meaning as the latter phrase. *See* Reg. §1.421-1(i)(2).

[33] When an ISO is exercised and, as a result, stock is transferred to the individual pursuant to a "qualifying transfer," as defined in the regulations, the optionee generally does not recognize income. *See* Reg. §1.421-2.

[34] Reg. §1.421-1(h)(2).

[35] Reg. §1.422-2(b)(1).

[36] Reg. §1.422-2(b)(3)(ii). *See also* PLR 9531031. See III.B.2., below, for a discussion of "evergreen" provisions and the sample stock option plan in the Worksheets for an example of an evergreen provision. Only the net number of shares that are issued pursuant to the exercise of a statutory option must be counted against the maximum aggregate number of shares. *See* preamble to T.D. 9144, 69 Fed. Reg. 46,401, 46,403 (Aug. 3, 2004) ("For example, if the exercise price of an option to purchase 100 shares equals the value of 20 shares, and the corporation permits the employee to use those 20 of the 100 shares to pay the exercise price of the option, and the corporation only issues 80 shares to the optionee, then 80 shares are counted against the maximum aggregate number of shares (rather than 100).").

[37] Reg. §1.422-2(b)(3)(i).

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under the plan and forfeited back to the plan, shares surrendered in payment of the exercise price of an option, or shares withheld for payment of applicable employment taxes and/or withholding obligations resulting from the exercise of options.[38]

If there is more than one plan under which ISOs may be granted and stockholders of the granting corporation only approve one single or collective maximum number of shares that are available for issuance under all such plans taken together, the stockholder approval requirements are not satisfied. A separate maximum number of shares available for issuance pursuant to ISOs must be approved for each plan.[39]

(3) *Eligible employees.* The plan must specify the employees or class(es) of employees eligible to receive ISOs.[40] If individuals other than employees may be granted NSOs or other stock-based awards under the plan, the plan must separately designate the employees or classes of employees eligible to receive ISOs.[41]

Practice Insight: Because there are no nondiscrimination or coverage rules for the granting of ISOs, the corporation has great discretion in granting ISOs. Because the corporation can grant options in its sole discretion, the usual practice is to provide that all employees are eligible to receive options and to give the board of directors and certain committees of the board of directors the authority and discretion to determine which employees will receive grants and the specific terms of such grants.[42]

(4) *Stockholder approval.* The plan must be approved by the stockholders of the adopting corporation[43] within 12 months before or after the "adoption" of the plan.[44] The mechanical requirements of obtaining stockholder approval (such as the required percentage of the shares that vote in favor of the plan) generally are determined under the corporate law applicable to the corporation.[45] An option may be granted before and made subject to stockholder approval, provided that the option is granted after the plan is adopted and the requisite stockholder approval is subsequently obtained in a timely fashion. The ability to grant ISOs before obtaining stockholder approval can be extremely important for corporations that rarely present matters to the stockholders other than at the annual stockholders' meeting. If the board of directors so specifies, such pre-stockholder-approval option grants are treated as granted on the date the corporation took the action to grant the options (not the later date of stockholder approval) even though they are conditioned on receiving later stockholder approval.[46]

(5) *Ten-year duration of the plan.* The plan cannot have a duration that exceeds 10 years from the earlier of the date the plan is adopted or the date the plan is approved by the stockholders.[47] Normally, the date of adoption of the plan is the date the plan is approved by the board of directors of the adopting corporation. As stockholder approval usually follows the adoption of the plan by the board of directors, the 10-year term of the plan generally commences with the adoption of the plan by the board of directors. If the corporation does not wish to grant ISOs before the approval of the plan by the stockholders, the adoption of the plan can be conditioned on obtaining stockholder approval, in which case the adoption of the plan and the obtaining of stockholder approval occur on the same day.[48] To grant ISOs after the expiration of the 10-year period, a new plan must be adopted and approved.[49] It is sufficient, however, for a corporation to re-adopt ("restate") an existing plan upon the conclusion of the 10-year period, provided that stockholder approval is obtained.[50] An option granted during the 10-year plan period is not disqualified even though the term of the option extends beyond the termination of the plan and even though the option is exercised after the termination of the plan, as long as the option, by its terms, was not exercisable after the expiration of 10 years (five years in the case of a greater-than-10% owner) from the grant date.[51]

(6) *Plan amendments.* The provisions relating to the maximum number of shares to be issued under the plan and the employees (or class or classes of employees) eligible to receive options under the plan are the only provisions of a stock option plan that must be approved by stockholders for purposes of §422(b)(1). Any increase in the maximum aggregate number of shares that may be issued under the plan (other than an increase merely reflecting a change

[38] Reg. §1.422-2(b)(3)(iii).

[39] Reg. §1.422-2(b)(3)(iv).

[40] §422(b)(1); Reg. §1.422-2(b)(4).

[41] Reg. §1.422-2(b)(4).

[42] *See* Reg. §1.422-2(b)(4) (plan may provide that "all employees of the corporation" are eligible to be granted options).

[43] Section 421 and §422 contemplate that only corporations (as opposed to other business entity forms) may grant (and only their employees may be granted) ISOs. *See, e.g.*, Reg. §1.421-1(a)(1) (defining "option" as "the right or privilege of an individual to purchase stock from a *corporation* by virtue of an offer of the *corporation* continuing for a stated period of time, whether or not irrevocable, to sell such stock at a price determined under paragraph (e) of this section, such individual being under no obligation to purchase") (emphasis added).

[44] §422(b)(1); Reg. §1.422-2(b)(2)(i).

[45] Reg. §1.422-3. *See also Brooks v. United States*, 30 F.3d 141 (10th Cir. 1994).

[46] §424(i); Reg. §1.421-1(c)(2). Ordinarily, a plan is adopted when it is approved by the granting corporation's board of directors, and the date of the board's action is the reference point for determining whether stockholder approval occurs within 12 months before or after such adoption. However, if the board's action is subject to a condition (such as stockholder approval) or the happening of a particular event, the plan is adopted on the date the condition is met or the event occurs, unless the board's resolution fixes the date of approval as the date of the board's action. Reg. §1.422-2(b)(2). Note, however, that such later approval by stockholders will have an effect for purposes of the granting corporation's financial statements. *See* II.J., below.

[47] §422(b)(2); Reg. §1.422-2(c).

[48] *See* Reg. §1.422-2(b)(2)(i).

[49] §422(b)(3); Reg. §1.422-2(c).

[50] Reg. §1.422-2(b)(2). Certain plan amendments that require shareholder approval may cause a deemed re-adoption of an existing plan. *See* PLR 200551015 (deemed re-adoption upon shareholder-approved amendment, which increased the maximum aggregate number of shares that could be issued under the plan; options granted under the plan at any time within 10 years from the date of shareholders' approval of amendment satisfied the 10-year period limitation).

[51] §422(b)(3); Reg. §1.422-2(d). See II.B.3., below, for a discussion of 10% owners.

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in the number of outstanding shares, such as a stock dividend or stock split), or change in the designation of the employees (or class or classes of employees) eligible to receive options under the plan, is considered the adoption of a new plan requiring stockholder approval within 12 months before or after such actions. In addition, a change in the granting corporation or the stock available for purchase or award under the plan is considered the adoption of a new plan requiring new stockholder approval within the prescribed 24-month period. Any other changes in the terms of an incentive stock option plan are not considered the adoption of a new plan and thus do not require stockholder approval under the Code.[52]

(7) *Additional provisions.* The plan may have provisions in addition to those required by §422 (including ways in which the employee can finance the exercise price of the ISOs) so long as the additional provisions are not inconsistent with the ISO requirements for those options intended to qualify as ISOs. See II.B.4., and II.E., below.

c. Option Agreement Requirements

The option agreement must meet the following requirements:

(1) *Written paper or electronic document.* The option agreement must be in writing and can be issued in paper or electronic form. The writing must be adequate to establish an option right or privilege that is enforceable under applicable law.[53]

(2) *Minimum provisions.* The option agreement must specify, at a minimum, the number of shares subject to the option, the exercise price at which the employer offers to sell the shares to the employee, the restrictions on exercise, if any, and the period of time during which the option remains open ("option term").[54] Additional provisions may be and frequently are included in the option agreement, provided such provisions are not inconsistent with the requirements for the option to qualify as an ISO. See II.E., below, for examples of additional provisions.

(3) *Ten-year option term.* The option agreement must provide that the option cannot be exercised more than 10 years (five years in the case of a 10% owner) after the date on which the option was granted.[55] See II.B.3., below, for a discussion of 10% owners.

(4) *Non-transferability.* The option agreement must provide that the option cannot be transferred other than by will or by the laws of descent and distribution.[56] The option agreement may give the optionee the ability to specifically designate the optionee's beneficiary.[57] An exercise of an option by a legal representative of the optionee (such as during the disability of the optionee) or by the estate of the optionee will not violate the prohibition on transfer. Except as discussed below, an exercise by an optionee's legal representative or by an optionee's estate is subject to the same provisions and limitations to which the optionee would be subject.

(5) *Not designated an NSO.* The option agreement, when the option is granted, must not provide that the option will not be treated as an ISO.[58]

d. Exercise Price Requirement

The exercise price must be not less than 100% of the fair market value of the stock that is subject to the ISO, as measured on the date the option is granted.[59] In the case of 10% owners, the option exercise price must be not less than 110% of such fair market value.[60] See II.B.3., below, for a discussion of 10% owners.

For purposes of determining the grant date of an ISO, a corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.[61] If an ISO grant is made contingent upon the optionee becoming an employee of the issuing corporation, the ISO will not be considered granted until the optionee commences service as an employee.[62] Accordingly, under those circumstances, the ISO would have to satisfy the requirements applicable to ISOs on the date on which the optionee commences service as an employee. In particular, the exercise price of the ISO would have to be equal to at least 100% of the fair market value of the option stock on the date the optionee commences service as an employee.

The imposition of a vesting schedule or other restrictions on when the employee may exercise the option does not delay the date of grant.[63]

Example: On June 1, 2022, T Corp. grants to D, an employee, an option to purchase 3,000 shares of T stock, exercisable by D on or after June 1, 2023, provided that D is still employed by T Corp. on that date and provided that T Corp.'s profits during the fiscal year preceding the year of exercise exceed $2 million. Such option is granted to D on June 1, 2022, and is treated as outstanding as of that date.[64]

If a share of stock is transferred to an individual pursuant to the exercise of an option that fails to qualify as an ISO merely because there was a failure of an attempt, made in good faith, in the terms of the option grant agreement to meet the minimum

[52] Reg. §1.422-2(b)(2)(iii).
[53] Reg. §1.421-1(a)(3).
[54] Reg. §1.421-1(a)(1).
[55] §422(b)(3); Reg. §1.422-2(d), §1.422-2(f).
[56] §422(b)(5); Reg. §1.422-2(a)(2)(v).
[57] Reg. §1.421-1(b)(2). The nontransferability requirements are not violated by a provision in an option agreement giving the optionee the ability to pledge stock actually purchased thereunder as security for a loan used to fund the purchase price. Also, the transfer of an option to a trust does not disqualify the option as an ISO if, under §671 and applicable state law, the individual is considered the sole beneficial owner of the option while it is held in the trust. If an option is transferred incident to divorce pursuant to §1041 or pursuant to a domestic relations order, the option does not qualify as an ISO as of the day of such transfer. Reg. §1.421-1(b)(2).
[58] §422(b); Reg. §1.422-2(a)(4).
[59] §422(b)(4); Reg. §1.422-2(a)(2)(iv).
[60] §422(c)(5); Reg. §1.422-2(f)(1).
[61] Reg. §1.421-1(c)(1).
[62] Reg. §1.421-1(c)(2).
[63] Reg. §1.421-1(c)(3).
[64] Reg. §1.421-1(c)(3).

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ISO exercise price requirement, the minimum exercise price requirements are nevertheless considered to have been met.[65] Whether there was a good faith attempt to set the option price at not less than the fair market value of the stock subject to the option at the time of grant depends on the relevant facts and circumstances.[66] For publicly traded stock that is actively traded on an established market at the time the option is granted, determining the fair market value of such stock by the appropriate method described in Reg. §20.2031-2[67] establishes that a good faith attempt to meet the ISO exercise price requirement was made.[68] For non-publicly traded stock, if it is demonstrated, for example, that the fair market value of the stock at the date of grant was based upon an average of the fair market values as of such date set forth in the opinions of completely independent and well-qualified experts, such a demonstration generally establishes that there was a good faith attempt to meet the ISO exercise price requirement.[69] Other methods of valuation, however, may qualify as good faith attempts to set the exercise price of an ISO. If the stock is non-publicly traded, the optionee's status as a majority or minority stockholder may be taken into consideration.[70] Regardless of whether the stock offered under an option is publicly traded, a good faith attempt to meet the ISO exercise price requirement is not demonstrated unless the fair market value of the stock on the date of grant is determined with regard to nonlapse restrictions (as defined in Reg. §1.83-3(h)) and without regard to lapse restrictions (as defined in Reg. §1.83-3(i)).[71] Amounts treated as interest and amounts paid as interest under a deferred payment arrangement are not includible as part of the ISO exercise price. Therefore, an attempt to set the ISO exercise price at not less than fair market value is not regarded as made in good faith if an adjustment of the exercise price to reflect amounts treated as interest results in the exercise price being lower than the fair market value on which the exercise price was based.[72]

Practice Insight: If the parties expect the stock to rise over time, the fair market value exercise price requirement places great pressure on the parties to grant the option as soon as possible, i.e., before the rise in value occurs. Thus, there frequently will be a desire to grant options before obtaining stockholder approval.[73] Although the same pressure creates a desire in some cases to grant options before employment actually commences, the grant of the option cannot occur before the commencement of employment.[74]

Practice Insight: The §409A regulations provide that the grant of an ISO does not constitute a deferral of compensation and thus is not subject to §409A.[75] The grant of an NSO also does not constitute a deferral of compensation if certain requirements are satisfied. Among these requirements is that the exercise price of the NSO never be lower than the fair market value of the underlying stock.[76] The good faith standard, which applies for purposes of satisfying the §422 requirement that the exercise price of an ISO be no less than fair market value, does not apply for purposes of determining whether an NSO meets the requirements to be exempt from §409A.[77] The good faith standard found in §422(c)(1) is thus less stringent than the fair market standard that an NSO must satisfy to avoid constituting "deferred compensation" under §409A.

The §409A regulations provide safe harbor valuation methods for determining whether an NSO satisfies the fair market value requirement to be exempt from §409A.[78] A corporation issuing an ISO that applies the safe harbor valuation methods and related rules set forth in the §409A regulations for valuing NSOs should be in compliance with the less stringent standard applicable to determining the exercise price of ISOs under §422. For example, if all of the other requirements in the §409A regulations are satisfied, a single qualified appraisal may satisfy the §409A safe harbor valuation methods, rather than an average of two appraisals as set forth in an example in the §422 regulations.[79]

2. *Post-Grant Requirements*

If an option qualifies as an ISO on the date it is granted, the option and the optionee must also meet certain requirements that are applied after the date of grant in order for it to remain an ISO at the time of exercise.

[65] Reg. §1.422-2(e)(2)(i). If the individual optionee is a 10% owner, however, such optionee may not rely on this "good faith attempt" safe harbor. Reg. §1.422-2(f)(1).

[66] Reg. §1.422-2(e)(2)(i).

[67] In general, Reg. §20.2031-2(b) provides various methods of calculating fair market value based on a variety of means and weighted averages of high, low, and closing selling prices on or near the valuation date.

[68] Reg. §1.422-2(e)(2)(ii).

[69] Reg. §1.422-2(e)(2)(iii).

[70] Reg. §1.422-2(e)(2)(iii).

[71] Reg. §1.422-2(e)(2)(iv). For a discussion of lapse and nonlapse restrictions, see 384 T.M., *Restricted Property — §83.*

[72] Reg. §1.422-2(e)(2)(v), §1.421-1(e)(1).

[73] See II.B.1.b., above.

[74] See II.B.1.a., above.

[75] Reg. §1.409A-1(b)(5)(ii).

[76] Reg. §1.409A-1(b)(5)(i)(A). In *Sutardja v. United States,* 109 Fed. Cl. 358 (2013), one of the first court cases to address the application of §409A to stock options, the Court of Federal Claims confirmed that *discounted* stock options constituted nonqualified deferred compensation for purposes of §409A. Discounted stock options, however, are typically created inadvertently and therefore not designed to comply with §409A (e.g., no fixed exercise date due to the fact that the option allows the holder to determine when to exercise and recognize taxable income). A non-compliant discounted stock option will subject the optionee to accelerated income recognition upon vesting (as opposed to upon exercise), an additional 20% income tax, and an additional interest penalty. See also CCA 201521013, in which the IRS Office of Chief Counsel concluded that a nonstatutory stock option violated §409A due, in part, to the fact that the exercise price was not at least equal to the fair market value of the employer's common stock (based on actual transactions in the common stock) as of the date of grant. In this regard, the term "date of grant" refers to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. *See* Reg. §1.409A-1(b)(5)(vi)(B)(1).

[77] See the discussion in III.D.4.a. of the preamble to T.D. 9321 (the final §409A regulations), 72 Fed. Reg. 19,234, 19,240 (Apr. 17, 2007).

[78] Reg. §1.409A-1(b)(5)(iv)(B). In the context of a privately held corporation, the regulations under §409A provide specific guidance on the alternative methods by which a corporation can determine the fair market value of its stock for purposes of establishing the exercise price of a stock option. The general rule is that the stock must be valued based on *a reasonable application of a reasonable valuation method.* Whether a valuation method is reasonable (or has been reasonably applied) will be evaluated based on the facts and circumstances. A valuation methodology, however, will not be considered reasonable if it does not take into account all available information material to the value of a corporation.

[79] *See* Reg. §1.422-2(e)(2)(iii).

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a. Continuous Employment Requirement

For an ISO to retain its status as an ISO, the optionee must remain an employee of the corporation granting the ISO (or a parent or subsidiary of the corporation) at all times during the term of the ISO, except for a period of up to three months immediately following the optionee's termination of employment.[80] The post-termination exercise period is literally three months and is not counted as 90 days.

Example: An employee terminating employment on June 30 will have until September 30 to exercise an ISO, even though September 30 is 92 days after June 30.[81]

Aside from this three-month rule, §422(a)(2) generally does not allow a break in employment of any length at any time during the term of the ISO.[82] Notwithstanding the continuous employment requirement, the ISO plan and the ISO agreement may allow an option to be exercised more than three months following termination of employment, but such an option will cease to qualify as an ISO (and thus be treated for tax purposes as an NSO) if it is exercised after the end of the three-month post-termination of employment period.[83]

Practice Insight: The 10-year limitation (five years in the case of a 10% owner) on ISO exercises must be specified in the ISO agreement (or plan under which the award is granted).[84] There is no requirement, however, that an ISO agreement expressly provide that the ISO be exercised, if at all, no later than three months following termination of employment.[85]

b. Relaxation of the Continuous Employment Requirement

If an optionee's employment terminates due to disability, the optionee must remain an employee of the corporation granting the ISO (or a parent or subsidiary of the corporation) at all times during the term of the ISO, except for a period of up to one year (rather than three months) immediately following the optionee's termination of employment.[86]

Military leaves of absence, sick leave, and any other bona fide leaves of absence (such as leave for government service) are not considered to sever the employment relationship during the term of the ISO as long as such leave does not extend beyond three months. If the leave extends beyond three months, the employment relationship is deemed to have been terminated as of the first day immediately following the three-month period unless the optionee's reemployment rights are guaranteed by law (such as the Family and Medical Leave Act, the Uniformed Services Employment and Reemployment Rights Act, and certain state maternity/paternity and disability leave laws) or by contract.[87]

If an optionee dies while still employed or within three months following termination of employment, additional time may be allowed for the estate to exercise the option, provided the exercise is in accordance with the terms of the option and the plan.[88] If the ISO agreement has a general restriction that the option must be exercised within three months following termination of employment, then, in order to take advantage of either the death extension or the disability extension provisions, the option plan or option agreement should clearly state the allowance for additional time to exercise the option.

Practice Insight: To avoid confusion, when an optionee dies or becomes disabled, plans typically provide the same amount of additional time to exercise options.

c. $100,000 Limitation on ISOs First Exercisable in a Year

Options are not treated as ISOs (but instead are treated as NSOs) to the extent that the aggregate fair market value of stock with respect to which ISOs are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000.[89] Fair market value of the stock is determined as of the date of grant of the

[80] §422(a)(2); Reg. §1.422-1(a)(1)(i)(B).

[81] Rev. Rul. 66-5.

[82] Certain leaves of absence are not considered to be breaks in employment for ISO purposes. See II.B.2.b., below.

[83] Reg. §1.421-1(h)(2). It should be noted, however, that for FICA purposes, §3121(a)(22) exempts "a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option (as defined in §422(b))" from the definition of "wages" for FICA purposes. As the continuous service requirement to qualify for ISO treatment is found in §422(a) and not in §422(b), it is at least arguable that FICA does not apply to the exercise of options that meet the requirements of §422(b) even though the exercise does not satisfy the continuous service requirement. A similar uncertainty exists for options that satisfy the §422(b) requirements but do not satisfy the $100,000 limitation in §422(d).

[84] See II.B.1.c., above.

[85] If an ISO is, in fact, exercised more than three months after termination, however, the optionee would not receive the special tax benefits afforded an ISO.

[86] §422(c)(6); Reg. §1.422-1(a)(3). The disability must be as described in §22(e)(3).

[87] Reg. §1.421-1(h)(2). *See, e.g.*, Reg. §1.421-1(h)(4) *Exs.* (6) and (7) (continuation of employee status by statute or contract beyond three months during periods of military service or sickness); preamble to T.D. 9144, 69 Fed. Reg. 46,401, 46,402 (Aug. 3, 2004) ("Thus, for example, if an optionee is on leave pursuant to the Family and Medical Leave Act, the Uniformed Services Employment and Reemployment Rights Act, or any similar statute providing for continued employment rights for an extended period, the employment relationship is considered intact."). A change from employee status to independent contractor status is a termination of employment, however, even though the same change in status might not constitute a "separation from service" for §409A purposes.

[88] Reg. §1.421-2(c). *See* Reg. §1.421-2(c)(4), which was amended with respect to the application of §1022 by 82 Fed. Reg. 6235, 6238 (Jan. 19, 2017) (basis upon death of optionee would be determined under §1014 or under §1022, if applicable). With respect to any determinations under §1014(a), the basis of property acquired by a beneficiary must be consistent with the basis reported for estate tax purposes. §1014(f), added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, §2004(a). *See also* §6035 (estate executors must furnish statement to IRS and property beneficiary stating property value), added by Pub. L. No. 114-41, §2004(b).

[89] §422(d); Reg. §1.422-4(a). An option that does not qualify as an ISO when granted (including an option which contains terms providing that it will not be treated as an ISO) is disregarded in determining whether the $100,000 limitation has been exceeded. Reg. §1.422-4(b)(1). In *Montgomery v. Commissioner*, 127 T.C. 43 (2006), the Tax Court rejected the taxpayers' argument that the $100,000 limit applies only to shares that are not subject to a subsequent disqualifying disposition during the same taxable year in which the shares were acquired and sustained the IRS's interpretation that the $100,000 limit applies to the aggregate fair market value of any stock a taxpayer may acquire pursuant to an ISO that is exercisable for the first time during such taxable year.

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ISO.[90] If an optionee holds more than one ISO, the options are taken into account in the order granted (and those granted earlier will first be accorded ISO status).[91]

Example (1): On September 19, 2019, an optionee is granted an ISO covering 5,000 shares at a time when the fair market value of the stock is $25 per share. The option is the only option held by the optionee. If the option is immediately exercisable in full, 4,000 shares of the option can qualify for ISO status and 1,000 cannot.

Example (2): The facts are the same as Example (1), except the ISO provides that it can be exercised immediately as to 4,000 shares and can be exercised after January 1, 2020, as to the remaining 1,000 shares. The entire 5,000 shares can qualify for ISO status.

Example (3): The facts are the same as Example (2). On March 3, 2020, the optionee is granted an additional ISO for 3,000 shares when the fair market value of the stock is $40 per share. The option is exercisable immediately. Of the $100,000 limitation for 2020, $25,000 is allocated to the ISO granted on September 19, 2019. Thus, 1,875 shares of the March 3, 2020, ISO satisfy the $100,000 limitation, and 1,125 shares do not.

An option is considered to be first exercisable during a calendar year if the option first will become exercisable at any time during that year, assuming that any condition on the optionee's ability to exercise the option related to the performance of services is satisfied. If an optionee is able to exercise the option in a year only if an acceleration provision is satisfied, then the option is considered to be exercisable in that year (for purposes of applying the $100,000 limitation) only if the acceleration provision is triggered before the end of that year. An acceleration provision includes, for example, a provision that accelerates the exercisability of an option on a change in ownership or control of the corporation, or a provision that conditions exercisability on the attainment of a performance goal.

After an acceleration provision is triggered, for purposes of applying the $100,000 limitation, the options subject to such provision and all other options first exercisable during a calendar year are then taken into account in the order in which granted. Because an acceleration provision is not taken into account before it has been triggered, however, an ISO that becomes exercisable for the first time during a calendar year by operation of such a provision does not affect the application of the $100,000 limitation with respect to an option (or portion thereof) exercised *before* such acceleration.[92]

An option is disregarded for purposes of the $100,000 limitation if, before the calendar year during which it would have otherwise become exercisable for the first time, the option is:

- modified and thereafter ceases to be an ISO;
- transferred in violation of the nontransferability requirements; or
- canceled.

If an option (or portion thereof) is modified, transferred or canceled at any other time, the option is treated as outstanding until the end of the calendar year during which it would otherwise have become exercisable for the first time.[93] A disqualifying disposition has no effect on the determination of whether an option exceeds the $100,000 limitation.[94]

Under the regulations, application of the $100,000 limitation may result in an option being bifurcated, i.e., being treated in part as an ISO and in part as an NSO. A corporation may issue a separate certificate for ISO stock or designate such stock as ISO stock in the corporation's transfer records or the plan records. The issuance of separate certificates or designation in plan records is not considered a modification, but in the absence of such an issuance or designation, shares are deemed purchased under an ISO first to the extent of the $100,000 limitation, and then the excess shares are deemed purchased under an NSO.[95]

Practice Insight: If an ISO is "early exercisable" (i.e., can be exercised before vesting with the shares acquired on such an exercise being subject to forfeiture if the vesting condition is not satisfied), then, read literally, §422(d) should be applied in the calendar year(s) in which the option is exercisable for the first time rather than the calendar year(s) in which the vesting condition is satisfied. In this regard, Reg. §1.421-1(g) specifically provides that, for purposes of §422, a transfer may occur even if a share of stock is subject to a substantial risk of forfeiture.

3. 10% Owners

If an ISO is granted to an individual who owns more than 10% of the total combined voting power of the corporation (or its parent or subsidiary), the exercise price must be at least 110% of the fair market value of the stock on the date of grant (rather than 100%) and the maximum term is limited to five years from date of grant (rather than 10 years).[96] In determining the minimum option price in the case of an optionee who is a 10% owner, the rules relating to the good faith determination of the option price do not apply.[97]

The determination of the percentage of the total combined voting power of all classes of stock of the employer corporation (or of its parent or subsidiary) that is owned by the optionee is made with respect to each such corporation by comparing the voting power of the shares owned (or treated as owned) by the optionee to the aggregate voting power of all shares of each such corporation actually issued and outstanding immediately before the grant of the option to the optionee. The aggregate voting power of all shares actually issued and outstanding immediately before the grant of the option does not include the

[90] §422(d)(3); Reg. §1.422-4(b)(2). See II.B.1.d., above, for a discussion of stock valuation.

[91] §422(d)(2). *See* Reg. §1.422-4(d) *Exs.* 1, 2.

[92] Reg. §1.422-4(b)(4). *See* Reg. §1.422-4(d) *Ex.* 4.

[93] Reg. §1.422-4(b)(5).

[94] Reg. §1.422-4(b)(6). *See* Reg. §1.422-4(d) *Ex.* 5(iv).

[95] Reg. §1.422-4(c). See the discussion regarding possible exemption from FICA withholding in II.B.2.a., above, where there is a violation of the employment requirement or the $100,000 limitation.

[96] §422(b)(6), §422(c)(5); Reg. §1.422-2(f)(1).

[97] Reg. §1.422-2(f)(1).

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voting power of treasury shares or shares authorized for issue under outstanding options held by the individual or any other person.[98]

For purposes of determining the stock ownership of the optionee, the stock attribution rules of Reg. §1.424-1(d) apply; these relate primarily to attribution from family members to an individual, and from entities to individuals that are owners or beneficiaries of such entities.[99] Stock that the optionee may purchase under outstanding options, however, is not treated as stock owned by the individual for purposes of determining whether that individual is a greater-than-10% holder and subject to the special ISO qualification rules.

4. Permitted Provisions in Plans and ISO Agreements

An ISO plan or the ISO agreement may contain provisions other than those discussed above, as long as they are not inconsistent with the above restrictions.[100] Such provisions could include, for example, option vesting, the right to pay the exercise price with corporation stock or promissory notes, same-day-sale arrangements (sometimes referred to using the misnomer "cashless" exercise arrangements), stock appreciation rights (including a tandem ISO/SAR in certain circumstances), rights of first refusal in favor of the corporation, a right in favor of the corporation to redeem the stock on termination of employment, or acceleration of vesting upon a change of control of the corporation. Some of these provisions are discussed more fully in II.E., below. A tandem ISO/NSO arrangement (i.e., if an ISO and an NSO are granted together and the exercise of one affects the right to exercise the other) is inconsistent with the ISO requirements and, therefore, is not a permitted arrangement for an ISO.[101]

C. Taxation of Employee

1. Grant of Option

An employee recognizes no taxable income upon the grant of an ISO. Although §83 requires employees and other service providers to recognize income when property is transferred to them in connection with their performance of services,[102] the grant by an employer of an option on the employee's stock is not treated as a transfer of property except in limited circumstances.[103] Furthermore, the income recognition provisions of §83 are explicitly made inapplicable to the transfer of an ISO by the rules under §83 and §421.[104]

2. Basis of Option

Because an employee does not recognize taxable income on account of the grant of an ISO and generally does not pay the exercise price or any other consideration for an ISO until exercise, the employee's basis in an ISO will generally be zero.[105] For practical purposes, the determination of the basis of the ISO itself (as opposed to the underlying stock) is of limited importance because an ISO, by definition, is not transferable except upon the death of the employee.[106] In special circumstances, however, the employee may have basis in an ISO either because the employee paid consideration for the option or because the ISO "attracted" basis from another transaction. For example, the grant of an ISO might trigger the loss disallowance rules under §1091 (the "wash sale rules") and thereby result in basis equivalence being attached to the ISO.[107] The most common circumstance in which an ISO might have basis is following the death of the holder of the ISO. The circumstances in which an ISO has basis or basis equivalence are sufficiently rare, and the added complexity is sufficiently great, that this Portfolio assumes that the basis of an ISO is zero except for the discussion in II.F., below, dealing with the death of the optionee.

3. Vesting of Option

When an option is granted, a participant may be subject to a risk of forfeiture of either the right to exercise the option ("exercise vesting") or the right to the underlying stock ("stock vesting"). There are no tax consequences as a result of exercise vesting occurring while the ISO remains unexercised, whether the vesting was contained in the original ISO grant or provided

[98] Reg. §1.422-2(f)(2).

[99] Reg. §1.422-2(f)(2).

[100] In a 1999 letter ruling, the Wage and Hour Division of the U.S. Department of Labor (DOL) concluded that the "profit element" of a stock option should be included in the employee's "regular rate" that would, in turn, be used to calculate overtime pay requirements under the Fair Labor Standards Act (FLSA). *See* DOL Op. Ltr., Office of Enforcement Policy Fair Labor Standards Team, Wage and Hour Division (Feb. 12, 1999). Reacting against this decision, Congress passed the Worker Economic Opportunity Act, Pub. L. No. 106-202, enacting 29 U.S.C. §207(e)(8), which effectively creates a "safe harbor" excluding stock options and similar rights from the FLSA base rate computation, provided certain requirements are met. These requirements include that: (1) the grants be made under a program communicated to participating employees in advance; (2) the stock right not be exercisable for at least six months after the grant (apart from circumstances such as death, disability, retirement, change in control or other circumstances permitted by regulation); (3) the exercise price be at least 85% of the stock's fair market value at grant; (4) the exercise of the stock right be voluntary; and (5) any determinations relating to performance-based terms of grants or stock rights be (a) based on certain types of performance criteria of any business unit consisting of at least 10 employees or of a facility established in advance or based on length of service or minimum schedule of hours or days of work, or (b) based on past performance in the sole discretion of the employer. Thus, in designing any ISO terms in addition to those absolutely required by the Code's restrictions, an employer may want to consider complying with the preceding FLSA safe harbor requirements, if it desires to avoid inadvertently increasing an employee's "regular rate" under the FLSA. Since the enactment of the safe harbor in 2000, neither the Wage and Hour Division, specifically, nor the DOL, generally, has addressed in any administrative decisions the question of how ISOs are to be included in the FLSA "regular rate" base. See U.S. Department of Labor Wage and Hour Division Fact Sheet #56 (rev. July 2008), stating with regard to the treatment of stock options under the Worker Economic Opportunity Act, "After reviewing the clear statutory language and thorough statement of legislative intent, the Department has determined that rulemaking is not necessary and refers the reader to the statute and Congressional Record for additional information." *See also* WHD Fact Sheet #56A (Dec. 2019).

[101] *See* Reg. §1.422-5(d)(2).

[102] Reg. §1.83-1(a)(1).

[103] §83(e); Reg. §1.83-3(a)(2), §1.83-7.

[104] Reg. §1.83-3(a)(2), §1.421-2(a)(1)(i). *See also* §83(e).

[105] §1012(a).

[106] *See* II.C.4., below.

[107] The definition of "a contract or option so to acquire substantially identical stock or securities" in §1091(a) and Reg. §1.1091-1(a) is broad enough to include an ISO and, thus, could trigger the basis adjustment rules of §1091(c) that would defer recognition of a loss on the disposition by creating a positive basis in the ISO. No authority has been found employing this result apart from the language of the Code and the wash sale regulations themselves.

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subsequently.[108] Similarly, no income is recognized as a result of stock vesting occurring while the ISO remains unexercised.[109]

4. Transfer, Cancellation or Lapse of Option

An ISO, by its terms, cannot be transferable except upon the death of an employee.[110] Care should be taken to distinguish between a "transfer" (i.e., the option survives the transfer and can be exercised after the transfer by the transferee) and a "cancellation" (i.e., the option ceases to exist).

Although the nontransferability rule is seemingly absolute on its face, the IRS has permitted transfers of ISOs to certain trusts treated as grantor trusts of the employee and, therefore, generally disregarded for income tax purposes.[111] Thus, the ISO agreement may permit the employee to transfer the ISO to such a trust and still qualify as an ISO. Furthermore, the ISO will retain its ISO status following the transfer to such a trust.

An employee may also transfer some or all of the ISO to the spouse of the employee pursuant to a divorce or domestic relations order; however, the option will cease to qualify as an ISO immediately upon such a transfer.[112] If retaining the ISO status is important for the parties to the divorce, they may want to consider having the ISO remain in the employee spouse's name but having the non-employee spouse retain all legal and beneficial ownership of the ISO to the extent consistent with the nontransferability and employee exercise rules of §422(b)(5).[113]

If an employer cancels an ISO in exchange for a cash payment or transfer of other consideration to an employee, the employee will be required to recognize ordinary income in an amount equal to the value of the consideration that the employer pays for such cancellation.[114] Such income will be subject to income tax withholding and employment taxes (and associated withholding).[115]

If an ISO lapses at the end of its term or otherwise without having been exercised, the employee will not be permitted to recognize a loss on account of the lapse, even if the ISO stock's fair market value exceeds the ISO exercise price at the time of the lapse.[116]

5. Exercise of Option

A key tax benefit of an ISO, compared to an NSO, is that the employee is not required to recognize income (either as ordinary income or capital gain) upon the exercise of the ISO.[117] In addition, the exercise of an ISO is not subject to income tax withholding or to employment taxes.[118] As discussed in II.C.8., below, however, the employee may incur a preference adjustment as a result of an exercise of an ISO and thereby incur additional alternative minimum tax.[119]

If, however, an ISO is exercised more than three months after the employee left the employ of the corporation granting the option, the option will cease to be eligible for this favorable tax treatment unless one of the special circumstances noted in

[108] Accelerating the exercise vesting (either pursuant to a predetermined triggering event or pursuant to a discretionary action) is not a modification of the ISO. *See* §424(h)(3)(C).

[109] See, however, II.G.1., below, for a discussion as to whether an acceleration of stock vesting may be a modification.

[110] §422(b)(5).

[111] Reg. §1.421-1(b)(2) provides, in part, that "the transfer of an option to a trust does not disqualify the option as a statutory option if, under §671 and applicable state law, the individual is considered the sole beneficial owner of the option while it is held in the trust." An issue has been raised as to whether transfers to other entities that are, like grantor trusts, disregarded apart from their beneficial owners (such as single member LLCs) may also be made without disqualifying an ISO. However, there is no explicit sanction in either published or unpublished IRS guidance for expanding this concept of permitted transfers to cases in which the transferees are disregarded entities other than grantor trusts. Given the general strictness of rules against transfers, a cautious approach would be to assume that the concept cannot safely be extended to other disregarded entities.

[112] *See* Reg. §1.421-1(b)(2) (disqualification as an ISO on transfer); Rev. Rul. 2002-22 (providing a similar result for NSOs transferred in divorce) ("A taxpayer who transfers interests in nonstatutory stock options and nonqualified deferred compensation to the taxpayer's former spouse incident to divorce is not required to include an amount in gross income upon the transfer. Rather, the former spouse is required to include an amount in gross income when the former spouse exercises the stock options or when the deferred compensation is paid or made available to the former spouse."). In Rev. Rul. 2002-22, the IRS explained that the same logic it applied to NSOs would also apply to ISOs ("The same conclusion would apply in a case in which an employee transfers a statutory stock option (such as those governed by §422 or §423(b)) contrary to its terms to a spouse or former spouse in connection with divorce. The option would be disqualified as a statutory stock option (*see* §422(b)(5) and §423(b)(9)) and treated in the same manner as other nonstatutory stock options. §424(c)(4), which provides that a §1041(a) transfer of stock acquired upon the exercise of a statutory stock option is not a disqualifying disposition, does not apply to a transfer of the stock option. *See* H.R. Rep. No. 795, 100th Cong., 2d Sess. 378 (1988) (noting that the purpose of the amendment made to §424(c) is to 'clarif[y] that the transfer of stock acquired pursuant to the exercise of an incentive stock option between spouses or incident to divorce is tax free').").

[113] A private letter ruling concluded that the fact that pursuant to a formal judgment on reserved issues, the employee spouse (E) was required to exercise the ISOs held by E for the benefit of the non-employee spouse (X) only in accordance with X's instructions and E was required to designate X as the beneficiary of X's share of the options, did not violate the transferability or exercisability requirements of §422(b)(5). E and X both resided in a community property state. The PLR further concluded that alternative minimum taxable income (AMTI) on E's exercise of X's ISOs would be includible in X's AMTI for federal tax purposes, and X would be entitled to any alternative minimum tax credits as a result of E's exercise of X's ISOs. The PLR also concluded that the transfer between E and X (or directly from the corporation to X) of stock resulting from the exercise of X's ISOs would not be a disposition of such stock under §424(c), and all subsequent tax consequences with respect to such stock would be X's. PLR 200519011. *See also* PLR 200737009.

[114] *See Bagley v. Commissioner*, 85 T.C. 663 (1985), *aff'd*, 806 F.2d 169 (8th Cir. 1986); PLR 7809072 (payments made in cancellation of a qualified stock option are taxable income to the employee; employer may take a tax deduction for such payments if the cancellation of the option is in satisfaction of a pre-existing obligation of a compensatory nature).

[115] *See* Rev. Rul. 67-366.

[116] In general, the failure to exercise an ISO should be treated as a sale of the ISO for no consideration. *See* §1234(a)(2), (gain on the sale of an ISO is not covered by §1234, *see* Reg. §1.1234-1(e)(1), but a loss is not excluded from §1234). Assuming the optionee has no basis, there is no loss to be recognized. It should be noted, however, that there may be tax consequences from the failure to exercise an in-the-money ISO in special circumstances. Such special circumstances might include, for example, a failure to exercise an in-the-money ISO when the optionee has received consideration to not exercise the ISO or when the effect of the failure to exercise the ISO results in the transfer of value to a related person.

[117] *See* §422(a), incorporating by reference the nonrecognition provisions of §421(a)(1).

[118] *See* §421(a)(1); Reg. §1.421-2(a)(1)(i).

[119] *See* §56(b)(3). It should be noted that the second sentence of §56(b)(3) is generally read to mean that there is no preference adjustment upon the exercise of the ISO if there is a disqualifying disposition of the shares acquired upon the exercise of the ISO and such disqualifying disposition occurs in the same calendar year as the exercise of the ISO.

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II.B.2.b., above, is present.[120] As a result, upon the exercise of the option, the former employee will be required to recognize ordinary income equal to the difference between the fair market value of the stock and any consideration paid by the former employee upon such option exercise.[121] Such income will be wages subject to income and employment taxes and associated withholding.[122] It should be noted that the requirement generally to exercise an ISO within three months after termination of employment (the "three-month rule")[123] is contained in §422(a) rather than in the definition of an ISO contained in §422(b). Accordingly, an ISO can permit exercise beyond the limit imposed by the three-month rule and still qualify as an ISO so long as the ISO is, in fact, exercised in compliance with the three-month rule.

6. Basis of ISO Stock

The employee's basis in ISO stock will be the amount the employee paid upon exercise of the ISO.[124] If the employee disposes of the ISO stock before expiration of the holding period (i.e., in a "disqualifying disposition" as described in II.C.7.c., below), however, such stock's basis will be increased by an amount equal to the amount included by the employee in ordinary income due to such disposition.[125]

7. Subsequent Disposition of ISO Stock

The tax treatment of the disposition of stock acquired through the exercise of an ISO depends upon whether the stock is disposed of before the end of the holding period specified in the statute. That period ends on the date that is the later of: (a) two years from the date of the ISO grant; or (b) one year from the date on which the ISO stock was transferred to the employee upon ISO exercise.[126] For purposes of computing these periods, the date of grant or exercise, as appropriate, is excluded, and the last day of the period is included.[127]

Example: If an option is granted on June 1, 2025, and is exercised on June 1, 2026, the holder must not dispose of the shares before June 2, 2027, in order to preserve ISO status.[128]

As discussed in II.B.1.d., above, the date on which an ISO is granted is generally the date on which all corporate action necessary for the grant of the ISO is completed, provided that the grant specifies the minimum exercise price of, and the maximum number of shares covered by, the ISO.

The transfer of ISO stock to an employee upon the employee's exercise of an option is deemed to occur upon the transfer of ownership of such stock or upon the transfer of substantially all the rights of ownership of such stock.[129] Although it is not necessary for the transfer to be evidenced immediately on the corporation's books for there to be a transfer of the ISO stock, it is important that the transfer be evidenced in such a manner within a reasonable time following the transfer.[130]

The IRS ruled in Rev. Rul. 70-335 that an employee acquired substantially all of the ownership rights in the stock underlying the option when the employee delivered written notice of exercise and full payment of the exercise price to the corporation in conformity with the terms of the stock option plan, even though the plan stated that the optionee would have no interest in the stock until the stock certificates were issued. The IRS ruled that the transfer occurred when the employee delivered notice and full payment to the employer, because the employee acquired substantial contractual and ownership rights to the stock at such time and the employer had no legal right to refuse to issue the option shares following such delivery. One court adopted a broader interpretation holding that a transfer of ISO stock occurred on the date on which the employee put a notice of exercise and full payment of the option price into the employer's internal mail system.[131]

The imposition of a vesting schedule does not delay the date of "transfer" for purposes of measuring the one-year disqualifying disposition holding period. Thus, assuming the transfer of the stock is recorded within a reasonable period of time following the exercise of the ISO, the one-year period for testing whether a disqualifying disposition has occurred should be measured from the day that the ISO is exercised,[132] even if the shares acquired upon the exercise of the ISO are subject to

[120] §422(a)(2); Reg. §1.421-1(h)(2), §1.422-1(a)(1)(i)(B). This three-month period is extended in a number of situations, such as "permanent and total disability" (within the meaning of §22(e)(3), see Reg. §1.422-1(a)(3)); death (see II.F., below); and certain leaves of absence (see II.B.1.a., above).

[121] Reg. §1.83-7(a). Note that the exercise of a nonqualified stock option, or a disqualifying disposition of an ISO after an employee retires, will not be considered earnings that would reduce Social Security benefits. *See* SSA Pub. No. 05-10077, *available at* https://www.ssa.gov/pubs/EN-05-10077.pdf, p. 14; IRS Pub. 957.

[122] While the better practice is to apply FICA withholding in this circumstance, the language of §3121(a)(22) suggests that FICA withholding may not apply as the option would still be described in §422(b) even though it could not qualify for the favorable tax treatment in §422(a).

[123] The term "three-month rule" is a shorthand reference to the rule requiring exercise of the ISO within a certain period of time after termination of employment. This three-month period is extended in a number of situations such as "permanent and total disability" (within the meaning of §22(e)(3), see Reg. §1.422-1(a)(3)); death (*see* II.F., below); and certain leaves of absence (*see* II.B.1.a., above).

[124] §1011.

[125] *See* Reg. §1.424-1(c)(4) *Ex.* 9.

[126] §422(a)(1); *see also* Reg. §1.422-1(a)(1)(i)(A).

[127] Rev. Rul. 66-5. Note that this computation practice also applies for the purposes of the three-month requirement in §422(a)(2) and the 10-year maximum term of the ISO requirement in §422(b)(3). *See* Rev. Rul. 70-412.

[128] Reg. §1.424-1(c)(4) *Ex.* 7. *But see* Reg. §1.424-1(c)(4) *Ex.* 1. Example 1 seems to suggest that a disposition on June 1, 2020 would not be a disqualifying disposition. Example 7 is clearly the more conservative interpretation of §422(a)(1).

[129] Reg. §1.421-1(g).

[130] Reg. §1.421-1(g). A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. Further, Reg. §1.421-1(g) clarifies that a transfer of stock on the exercise of an option does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time or the share is subject to a right of first refusal at the share's fair market value at the time of sale.

[131] *Becker v. Commissioner*, 378 F.2d 767 (3d Cir. 1967), *rev'g* 46 T.C. 613 (1966).

[132] Reg. §1.422-1(a)(1)(i)(A) provides that, in for an individual to avoid a disqualifying disposition of a share of ISO stock, the individual must make "no disposition of such share before the later of the expiration of the two-year period from the date of grant of the option pursuant to which such share was transferred, or the expiration of the one-year period *from the date of transfer* of such share to the individual." (emphasis added).

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provisions that would constitute a substantial risk of forfeiture if §83 applied.

a. What Is a Disposition?

A disposition of ISO stock generally means any sale, exchange or gift of, or transfer of legal title to, the stock.[133] Section 424(c), however, provides the following exceptions to this general rule:

(1) A transfer from a decedent who held ISO stock to the decedent's estate or a transfer by bequest or inheritance is not considered a disposition of the ISO stock by the decedent.[134]

(2) An exchange of ISO stock in a nonrecognition transaction to which any of the following Code sections apply is not considered a disposition of the ISO stock: (a) §354 (exchange of stock in a reorganization); (b) §355 (distribution of stock of a controlled corporation); (c) §356 (receipt of additional consideration in a §354 or §355 transaction);[135] or (d) §1036, relating to stock-for-stock exchanges (or so much of §1031 as relates to §1036, i.e., instances in which stock is exchanged for stock and other property).[136]

Practice Insight: If §356 applies to a transaction, it applies in determining the amount of gain to be recognized.[137]

(3) A pledge or hypothecation of ISO stock is not considered a disposition of the stock. If the stock is transferred to another person pursuant to that pledge or hypothecation, however, such transfer is considered a disposition.[138]

(4) A transfer of ISO stock between spouses or incident to a divorce within the meaning of §1041(a) is not considered the disposition of ISO stock, and the spouse who receives the stock will be entitled to receive the same tax treatment on the subsequent disposition of the ISO stock as the tax treatment to which the employee would have been entitled.[139]

(5) The acquisition of ISO stock in the name of the employee and another jointly with right of survivorship or the subsequent transfer of ISO stock into such joint ownership will not be considered a disposition at the time of initial acquisition or transfer into joint ownership.[140] A change in joint owners, however, is considered to be a disposition of ISO stock.[141] If there is a termination of joint ownership occurring other than upon the death of one of the joint owners, the termination of joint ownership will be considered a disposition of the ISO stock, except to the extent that such termination results in the employee reacquiring full ownership of the shares. The transfer of ownership resulting from the death of one of the joint owners of the stock will not be considered a transfer of ownership of the ISO stock.[142]

(6) A transfer of ISO stock by an insolvent individual to a trustee in bankruptcy, a receiver or any other similar fiduciary in any proceeding under the Bankruptcy Code or any other similar insolvency proceeding is not considered to be a disposition of such ISO stock, nor is any subsequent transfer of that stock for the benefit of the insolvent individual's creditors.[143]

Form seems to count when determining whether there has been a disposition of ISO stock. For example, the IRS has treated as a disposition the transfer of legal title to option stock to the trustee of a blind trust who has the right to sell the stock,[144] while it has ruled that the delivery of an irrevocable power of attorney to an agent who has the power to sell the stock is not a transfer because the employee still held title to the stock.[145] The IRS has also ruled that the purchase of a put option on option

[133] §424(c)(1). Except for cases arising in the Ninth Circuit, an involuntary disposition is a disposition. *See Kast v. Commissioner*, 78 T.C. 1154 (1982); Rev. Rul. 74-267. In the Ninth Circuit, *Brown v. United States*, 427 F.2d 57 (9th Cir. 1970), where the court ruled that an involuntary disposition is not a disposition under §421, still has precedential effect. Accordingly, the Tax Court will follow *Brown* for taxpayers in the Ninth Circuit, under the Tax Court's procedural rule of *Golsen v. Commissioner*, 54 T.C. 742, 756–58 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The author believes that the *Brown* decision is so flawed that we will not discuss it in this Portfolio, and taxpayers and practitioners in the Ninth Circuit should proceed with caution before relying on *Brown*. *See also Schumann v. Commissioner*, T.C. Memo 1983-35, *aff'd*, 857 F.2d 808, 810–12 (D.C. Cir. 1988) (explaining errors in the Ninth Circuit's analysis). In Rev. Rul. 74-267, the IRS stated that it will not follow the decision in *Brown*.

[134] §424(c)(1)(A).

[135] *See* CCA 201519031 (applying these rules to (1) a merger to which §356 applies and (2) a merger to which neither §354 nor §356 applies).

[136] §424(c)(1)(B). Pursuant to Reg. §1.424-1(c)(3), if an optionee exercises an ISO with statutory option stock and the applicable holding period requirements with respect to such stock are not met before the transfer, these nonrecognition provisions do not apply to determine whether there is a disposition of those shares. Therefore, there is a disposition of the statutory option stock, and special tax treatment does not apply. *See* CCA 201519031 (exchange of stock not a disposition under §424(c)(1) where §356 applies because exchange is made pursuant to reorganization described in §368(a); where exchange made pursuant to reorganization not described in §368(a), disposition falls within meaning of §424(c)(1) because neither §354 nor §356 applies).

[137] *See* CCA 201519031.

[138] §424(c)(1)(C); Reg. §1.424-1(c)(1)(iii).

[139] §424(c)(4); Reg. §1.424-1(c)(1)(iv). Note, however, that if an option is transferred incident to divorce (within the meaning of §1041(a)) or pursuant to a domestic relations order, the option does not qualify as a statutory option as of the day of such transfer. Reg. §1.421-1(b)(2). For a discussion of §1041, see 515 T.M., *Divorce and Separation*. *See also* II.C.4., above.

[140] §424(c)(2); *see also* PLR 9021046 (transfer of ISO stock to revocable trust jointly owned with spouse not considered a disposition), PLR 9309027 (transfer of stock acquired by exercise of ISOs to grantor trust not a disposition of stock, even if it occurred within holding period specified in §422(a)(1)).

[141] Reg. §1.424-1(c)(2).

[142] Reg. §1.424-1(c)(2), (basis upon death of joint tenant would be determined under §1014 or under §1022, if applicable), effective January 19, 2017. With respect to any determinations under §1014(a), the basis of property acquired by a beneficiary must be consistent with the basis reported for estate tax purposes. §1014(f). *See also* §6035 (estate executors must furnish statement to IRS and each property beneficiary stating property value).

[143] §422(c)(3).

[144] Rev. Rul. 74-243. *But see* CCA 201343021. Although treating a transfer of option stock to a blind trust as a disposition might appear to be a harsh result, many blind trusts are established in connection with complying with the conflict of interest rules for government service. Accordingly, §421(d) might provide relief. See discussion in II.C.7.c., below.

[145] Rev. Rul. 73-30.

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stock is not a disposition,[146] while the execution of a short sale transaction for option stock is a disposition.[147]

Practice Insight: Even if a put does not result in disposition for the purposes of §424(c), practitioners should consider the possible application of §1092 and §1233 for gain or loss characterization and timing purposes.

b. Disposition After Holding Period Expires

When an employee disposes of ISO stock after completion of the statutory holding period (i.e., after the stock has been held more than two years after the date the option was granted and more than one year after the date the option was exercised), the employee will be required to recognize the difference between the amount received in such disposition over the employee's basis in the ISO stock as capital gain.[148]

c. Disqualifying Disposition

If an employee disposes of ISO stock before the statutory holding period expires, the disposition will be considered a "disqualifying disposition."[149] A disqualifying disposition generally requires the employee to recognize as ordinary income, in the tax year during which the disqualifying disposition occurs, the difference between the ISO's exercise price and the ISO stock's fair market value at the time of option exercise (the "bargain purchase element").[150] The employee must recognize this income without reduction for any brokerage fees or other costs paid in connection with the disposition.[151] The ordinary income recognized is added to the ISO stock's basis to determine the capital gain that must be recognized on the disqualifying disposition. In determining whether there has been a disqualifying disposition, each share of ISO stock is considered separately; the disqualifying disposition of one share of ISO stock does not affect the taxation of any other ISO stock held by the individual.[152]

Example (1): On January 1, 2021, B, an employee of X Corp, is granted 100 ISOs to purchase shares of X Corp stock at $10 per share, the fair market value of X Corp stock on the date of grant. On February 1, 2023, B exercises all of the ISOs when the price of X Corp stock is $15 per share. On November 1, 2023 (a date that does not satisfy the ISO holding period), B sells 60 shares of X Corp stock acquired pursuant to the ISO for $17 per share. B must recognize $300 of ordinary income (60 shares multiplied by the bargain purchase element at exercise of $5) in 2023. In addition, B must recognize $120 of capital gain in 2023 due to the sale of the stock (60 shares multiplied by the difference between the $17 per share sales price and the basis of the ISO stock of $15, which is the sum of the exercise price for each share, $10, plus the additional ordinary income recognized in 2023, $5). This will be short-term capital gain because B did not hold the stock for more than one year following the exercise of the ISO.[153]

If the price that the holder of ISO stock receives for the ISO stock in a disqualifying disposition is less than the fair market value of the stock on the exercise date and the disposition is a transaction in which a loss, if sustained, would otherwise be recognizable under the Code, then the amount of ordinary income that the holder of ISO stock would recognize is the excess, if any, of the amount realized on the sale or exchange over the adjusted basis of the ISO stock.[154]

Example (2): Use the same facts as in the previous example, except that on November 1, 2023, B sells 60 shares of ISO stock before the end of the ISO holding period for $14 per share. B would be required to recognize $240 in ordinary income in 2023 (60 shares multiplied by the difference between the $14 realized on the disqualifying disposition and B's $10 basis (equal to the ISO exercise price)).[155]

Section 83 does not apply for ordinary income tax purposes on the date of the exercise of an ISO and therefore, the option holder cannot make an effective §83(b) election with respect to ordinary income tax at that time (although a §83(b)

[146] Rev. Rul. 59-242. The current validity of Rev. Rul. 59-242 is uncertain. On the one hand, it seems to rest on the similarity between a put and a short sale "against the box." As a short sale against the box is now a disposition (*see* Rev. Rul. 73-92 and §1259), the logic of Rev. Rul. 59-242 must be questioned. On the other hand, §1259 makes clear that a put does not have to be treated as a constructive sale in the same manner as a short sale against the box. Although taxpayers probably can continue to rely on Rev. Rul. 59-242, caution is advised, given the uncertainty as to whether Rev. Rul. 73-92 and §1259 reversed the holding in Rev. Rul. 59-242.

[147] Rev. Rul. 73-92. This result was subsequently codified in §1259.

[148] Reg. §1.424-1(c)(4) *Ex.* 2; §1001(a).

[149] In a wrinkle that is of no current practical significance but is noted here in case the law is changed so that it becomes of practical significance, the IRS applied this rule even in the case of an elective "deemed" disposition. See IRS Info. Letter 2002-0137, in which taxpayers were allowed (under §311(e) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34) to take advantage of a lower capital gains rate, where holding periods began after a certain date, to "deem" their ISO-acquired stock disposed of and then reacquired on the next day, at which point the holding period under the lower rate would begin. It is interesting that this undesirable result of a "deemed" disqualifying disposition was only possible as to ISO stock that had actually been acquired; the taxpayer's request to be considered to be "deemed" to have exercised ISOs not exercised in fact and then in turn be "deemed" to sell and reacquire such stock (in a non-disqualifying disposition, to boot) in order to start the lower-rate holding period for those shares was denied because "[t]here is no provision in … the ISO rules providing for a 'deemed exercise.'"

[150] §421(b); Reg. §1.421-2(b)(1).

[151] Reg. §1.421-2(b)(1).

[152] Reg. §1.421-2(a)(2).

[153] Assuming B did not sell the remaining 40 shares in 2023, B will have a preference adjustment in 2023 for AMT purposes of $200 (40 shares multiplied by the bargain purchase element at exercise of $5). There is no preference adjustment as to the 60 shares, as they were sold in the same calendar year as the exercise of the ISO. *See* II.C.8., below.

[154] §422(c)(2); Reg. §1.422-1(b)(2). Thus, for example, if a disqualifying disposition is a sale described in §1091 (relating to loss from wash sales of stock or securities), a gift (or any other transaction which is not at arm's length), or a sale described in §267(a)(1) (relating to sales between related persons), this special rule does not apply because a loss sustained in any such transaction would not be recognized. In PLR 9308021, the IRS ruled that §422(c)(2) does not apply if ISO stock is transferred to a charitable remainder trust within the one-year holding period of §422(a). The IRS determined that §422(c)(2) would not apply because the transfer would have been either a gift or subject to §267 (which disallows recognition of a loss from a sale or exchange between a grantor and the fiduciary of a trust). The taxpayer recognized the spread on exercise as ordinary income.

[155] As was the case in *Example (1)*, assuming B did not sell the remaining 40 shares in 2023, B will have a preference adjustment in 2023 for AMT purposes of $200.

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election is permissible for AMT purposes).[156] Thus, attempting to make such an election will not affect the amount that must be included if there is a disqualifying disposition.

Certain federal employees in the executive branch are required to divest property in order to comply with conflict-of-interest rules. Such an employee, the employee's spouse, and minor or dependent children (defined as an "eligible person" in §1043(b)(1)) who are required to sell shares of stock acquired pursuant to the exercise of an ISO for purposes of complying with the federal conflict-of-interest rules are treated as satisfying the statutory holding period.[157] Therefore, the eligible person is not considered to have made a disqualifying disposition and may treat any gain from the sale of the underlying stock as capital gain. In addition, these eligible persons may elect under §1043 to postpone recognizing any gains from a divestiture by investing in replacement property within 60 days following the date of the sale.

Practice Insight: Perplexing issues arise in the context of a disqualifying disposition that also qualifies for the installment method of reporting gain under §453.[158] The issue is particularly acute in situations where the sale is for contingent consideration that represents the predominant portion of the total consideration. An in-depth discussion of the issues is beyond the scope of this Portfolio but the following example illustrates the issues.

> *Example:* ABC Corp. is a privately held corporation. All of the outstanding stock of ABC Corp. was acquired by XYZ Corp. on June 30, 2017, for an upfront cash payment of $100 million paid at closing plus a possible earn-out payment of up to $400 million plus interest at the applicable federal rate. For simplicity, assume the earn-out payment is all or nothing depending on achieving a particular milestone (i.e., either $400 million plus interest will be paid or zero dollars will be paid) and was paid, if at all, on June 30, 2019. Thus, the purchase price for the ABC Corp. stock will be either $100 million or $500 million. Joe holds a fully vested but unexercised ISO for 1% of the ABC Corp. stock. The exercise price of the ISO is $400,000. Let us assume that we know that shortly before the closing of the merger the expected present value of the earn-out (i.e., taking into account all relevant factors such as the likelihood that the milestone will be achieved, time value of money, credit worthiness of XYZ Corp., etc.) is $240 million. Assume, therefore, that shortly before the closing of the merger the current fair market value of the stock subject to Joe's ISO is $3.4 million (i.e., 1% of ($100 million plus $240 million)). Also assume that the transaction is such that a loss (if sustained) would be recognized (i.e., §422(c)(2) can apply).
>
> What if Joe were to exercise his ISO shortly before the closing of the sale of ABC Corp. to XYZ Corp.? Joe would pay $400,000 to ABC Corp. to exercise his option and receive ABC Corp. stock worth $3.4 million. In the merger, Joe would sell his ABC Corp. stock to XYZ Corp. and receive $1 million in cash as his share of the upfront payment plus a contingent right to receive 1% of any earn-out payment.
>
> What are the federal income tax consequences to Joe assuming that the sale to XYZ Corp. is a disqualifying disposition and does not qualify for "open transaction"[159] treatment?
>
> Joe's tax advisors have a quandary: what is the "amount realized" by Joe for purposes of §422(c)(2)?
>
> *Non-Contingent Approach.* While there is no clear authority, some practitioners might conclude that the amount realized for purposes of §422(c)(2) should be limited to the non-contingent payment of $1 million (the "Non-Contingent Approach"). Under the Non-Contingent Approach, Joe's amount realized would be $1 million so that §422(c)(2) would limit the amount that Joe recognizes as compensation income to $600,000 (the excess of $1 million over the $400,000 exercise price).
>
> *Total Value Approach.* Using a more traditional understanding of "amount realized," other practitioners might conclude that the amount realized by Joe is at least $3.4 million (the "Total Value Approach"). Under this view, §422(c)(2) would not limit the amount of ordinary income recognized by Joe.
>
> There is an additional quandary for Joe's tax advisors. Joe's sale of his stock for an installment obligation (for purposes of §453) and the disqualifying disposition (for purposes of §421(b)) occur simultaneously. This raises the issue of whether §453 should be applied before the §421(b) provisions (the "§453 First Approach") or, conversely, whether §421(b) should be applied first (the "§421(b) First Approach"), because the exercise of the ISO occurred before the disposition. If Joe is not independently wealthy, the Total Value Approach combined with the §421(b) First Approach could cause significant hardship for Joe. Assuming Joe's combined tax rate on ordinary income is 40%, his 2009 tax attributable to $3 million of ordinary income would be $1.2 million even though the cash he received in 2009 is only $1.0 million. If the earn-out is zero, his capital loss in 2017 might never generate any significant tax benefits.
>
> If the §453 First Approach is adopted, it makes little difference to Joe if one applies the Non-Contingent Approach or the Total Value Approach. Under either approach, Joe will recognize the same gain in each year. The difference for Joe will be the difference (probably small) between ordinary income and short-term capital gain. On the other hand, the deduction available to ABC Corp. (Joe's employer) will differ dramatically under the two approaches.

8. Alternative Minimum Tax Considerations

Although the exercise of an ISO does not result in current taxable income, there are alternative minimum tax (AMT) implications. When calculating income for AMT purposes, the fa-

[156] Reg. §1.422-1(b)(2), Ex. 2.

[157] §421(d).

[158] As publicly traded stock cannot qualify for installment sale reporting under to §453(k)(2)(A), this issue generally arises in the context of the sale of a privately held corporation.

[159] *See Burnet v. Logan*, 283 U.S. 404 (1931). *See also* FSA 1993-0715-4; S. Rep. No. 96-1000, 96th Cong., 2d Sess. (1980) (stating that following the passage of the Installment Sales Revision Act of 1980, the open transaction theory should be limited to rare and extraordinary circumstances).

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vorable tax treatment of §421(a) is disregarded, and the bargain purchase element of the ISO will be considered a preference adjustment (i.e., as part of alternative minimum taxable income (AMTI) for the year in which the option is exercised).[160] If, however, a disqualifying disposition occurs in the year in which the option is exercised, there is no preference adjustment with the result that the amount that will be included as AMTI is the gain for regular tax purposes on the disposition of the ISO stock.[161]

Generally, AMT incurred by an optionee will result in an AMT credit carryforward for use in future years.[162] This credit, however, may be used to offset regular tax only to the extent such regular tax exceeds the tentative minimum tax.[163] The basis of the ISO stock for determining gain or loss for AMT purposes will be the exercise price for the ISO stock increased by the amount that AMTI was increased due to the earlier exercise of the ISO.[164] Thus, for example, should there be a disqualifying disposition in a year other than the year of exercise, the ordinary income on the disqualifying disposition will not be considered income for AMT purposes.[165]

There exists a substantial trap for the unwary taxpayer who exercises an ISO that results in the taxpayer paying AMT due to the preference adjustment on exercise. If the taxpayer retains the stock while the stock declines in value, the resulting AMT (even after the application of the AMT credit carryforward) may be more than the amount realized on the eventual sale of the stock. While a complete discussion of this issue is beyond the scope of this Portfolio, an example can illustrate the potential problem.

Example: B exercises an ISO in 2022 at a time when the stock's price is quite high. B's aggregate exercise price is $50,000. For the purposes of this example, assume the following: (i) as a result of such exercise, B pays additional AMT of $100,000 in 2022 and generates an AMT credit carryforward of an equal amount; (ii) the value of the stock declines, and in 2023 B sells the stock for $50,000; and (iii) in 2023 and all later years, B's regular tax is equal to his AMT. In this example, B will have made no profit as a result of the exercise of the ISO and the sale of the stock, but B will have paid $100,000 in extra tax. Because B's regular tax never exceeds B's AMT in 2023 and later years, B derives no tax benefit from the AMT credit carryover.

B could have avoided the problem by selling the stock in 2022 (i.e., the year in which B exercised the ISO) in a transaction in which a loss, if sustained, would have been recognized. By selling the stock in 2022, B avoids the preference adjustment. By selling in a transaction in which a loss, if sustained, would be recognized, B is able to take advantage of the gain limitation rule in §422(c)(2).

Trying to employ the strategy of avoiding AMTI by selling the stock in the same year as the exercise of the ISO where the fair market value of ISO stock drops below its fair market value on the exercise date has its own trap for the unwary. Assume in the above example that B had sold the stock in 2022 when it had declined in value to $50,000, but B liked the stock and immediately repurchased it for $50,000. This strategy clearly does not work as intended. Even though B did not have a loss with respect to the stock (i.e., B sold the stock for what he paid for it), B engaged in a wash sale under §1091.[166] Accordingly, the limitation of §422(c)(2) does not apply, and B will recognize ordinary income for regular tax purposes equal to the aggregate bargain element on the exercise of the ISO and generate a capital loss from the sale (which capital loss is not recognized due to §1091).[167] The strategy would have worked

[160] §56(b)(3). This "spread" between the option price and the fair market value of the ISO stock at exercise is treated as an "item of adjustment" for AMT purposes. *See, e.g.*, *Kadillak v. Commissioner*, 127 T.C. 184 (2006), *aff'd*, 534 F.3d 1197 (9th Cir. 2008). Section 56(b)(3) provides that §421 does not apply to the exercise of an ISO for the purposes of AMT. Thus, §83 applies because §83(e)(1), which excludes ISO exclusions from §83, would not apply. Therefore, if the shares are subject to a substantial risk of forfeiture as defined in §83, the date for the calculation of the preference adjustment and for inclusion of the adjustment in the calculation of AMTI is the substantial risk of forfeiture lapses unless the taxpayer files a §83(b) election within 30 days following the exercise of the ISO. In *Merlo v. Commissioner*, 492 F.3d 618 (5th Cir. 2007), *aff'g* 126 T.C. 205 (2006), the Fifth Circuit held that a corporation's insider trading policy that prevented employees from trading corporation stock during certain blackout periods did not create a substantial risk of forfeiture and, therefore, did not permit an employee to avoid recognition of income for AMT purposes upon the exercise of an ISO. Instead, the employee was required to recognize AMTI in the taxable year in which he exercised the option, even though the value of the acquired stock rapidly declined soon after the option was exercised. The court distinguished the situation in which the corporation's insider trading policy prevents employees from trading corporation stock during certain blackout periods from the situation in which an employer's insider trading policy requires an employee to sell stock acquired under an option back to the corporation at the original cost if the employee desires to sell the stock within one year of exercising the option. Unlike the latter situation, which creates a substantial risk of forfeiture until the sellback provision lapses, the employee in *Merlo* could not be compelled to return his shares of stock. The court found that the mere fact that a restriction prevented the employee from transferring the shares during the blackout period was not enough to cause the employee to forfeit the shares. *See also* TAM 200338010.

[161] §56(b)(3). *See In re Pavlosky*, 97 AFTR2d 2006-2916 (Bankr. S.D. Tex. 2006), *aff'd*, No. 06-CV-2061, 2006 BL 188785 (S.D. Tex. 2006), *aff'd*, 256 F. App'x 690 (5th Cir. 2007), in which the taxpayers argued that, according to legislative history, the amount included in AMTI does not exceed the amount realized on the sale or exchange of the stock over the adjusted basis of the stock. The court rejected this claim because the taxpayers did not buy and sell their stock in the same taxable year, noting that §56(b)(3) states that §422(c)(2) shall apply only when the disposition and inclusion are within the same taxable year. See the discussion in II.C.7., above.

[162] The credit permitted is the amount of adjusted net minimum tax reduced by the minimum tax credit for all prior tax years. *See* §53(b).

[163] §53(c).

[164] §56(b)(3).

[165] H.R. Rep. No. 795, 100th Cong., 2d Sess. 90 (1988).

[166] The wash sale rules in §1091(a) and Reg. §1.1091-1 disallow a loss sustained upon a sale or other disposition of securities if, during the period beginning 30 days before the sale date and ending 30 days after the sale date, the taxpayer acquires new securities substantially identical to the disposed securities.

[167] Some tax advisors apparently have incorrectly assumed that if the ISO stock is not actually sold at a loss, §1091 is inapplicable. Thus, they argue, the amount realized on sale (rather than the spread at exercise) can be used to calculate the ordinary income from the disqualifying disposition. Unfortunately, §422(c)(2)(B) provides that the lower "gain on sale" value can only be used to calculate the ordinary income component of a disqualifying disposition if the disposition is such that a loss (if sustained) would be recognized. If an individual engages in a sale and repurchase during the period beginning 30 days before the sale date and ending 30 days after the sale date, favorable treatment under §422(c)(2) is unavailable because a loss, if sustained, would not be recognized by virtue of §1091. *See* Reg. §1.422-1(b)(2)(ii), §1.422-1(b)(3) *Ex.* 3(iii). The fact that a loss is not actually sustained does not change the analysis, because the "loss (if sustained)" language is simply a requirement that the sale or ex-

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if B had refrained from purchasing the replacement stock during the period that would trigger the wash sale rules in §1091 and the sale did not implicate another loss disallowance provision.

Much has been written about the plight of the taxpayer who exercises an ISO with a significant spread on exercise and holds the ISO stock while it declines substantially in value. Such a taxpayer may incur an AMT that far exceeds the resulting value of the stock. Taxpayers who have argued for relief in such situations have routinely been denied any such relief.[168]

Former §53(e) provided for individuals with long-term unused credits for tax years beginning after 2007 and before January 1, 2013, to receive a refundable credit equal to the "AMT refundable credit amount."[169] Former §53(e) was struck in 2014 by §221(a)(8)(A)(i) of the Tax Increase Prevention Amendments Act.[170]

For further discussion of AMT considerations, see 587 T.M., *Noncorporate Alternative Minimum Tax*.

9. Golden Parachute Tax Considerations (§280G and §4999)

Section 280G(a) denies a deduction for an "excess parachute payment" and §4999 imposes a 20% excise tax on the recipient of an "excess parachute payment."[171] Section 280G(b) generally defines "excess parachute payment" as a payment in the nature of compensation to a disqualified individual that is contingent on a change in control of a corporation or a substantial portion of its assets,[172] that exceeds certain thresholds, and that does not qualify for an exemption. A "disqualified individual" is generally an individual that is an employee or independent contractor of the corporation and that, with respect to the corporation, is an officer, highly compensated individual, or 1% shareholder.[173]

If an option is granted due to a change in control, or if the vesting or exercisability of an option is accelerated due to a change in control, the value of the grant or the acceleration may be subject to §280G and §4999.[174] Furthermore, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value.[175]

10. IRS Right to Levy

If a person is liable for any federal tax and does not pay within 10 days after notice and demand by the IRS, the IRS may collect the tax by levy upon all property and rights to property belonging to the person, with certain exceptions.[176] The IRS Office of Chief Counsel has informally adopted the position that the IRS can enforce a levy by seizing and selling executive stock options, regardless of restrictions on the transferability of the options.

In CCA 200926001, a taxpayer subject to an IRS levy held ISOs and nonqualified stock options that were transferable only by will, the laws of descent or distribution, or pursuant to a qualified domestic relations order. Before the IRS served the notice of levy, the taxpayer's rights to the options vested pursuant to a separation agreement executed at termination of his employment. A settlement agreement was executed in subsequent arbitration proceedings, after the notice of levy was served. Under the settlement, the corporation said that it would comply with any and all liens, judgments, garnishments, levies, and the like relating to the taxpayer, and the taxpayer's exercise of options would be subject to such liens and judgments. Because the taxpayer had a vested right to the options as of the date of the separation agreement, the Office of Chief Coun-

change transaction be one in which the recognition of a loss would be permitted.

[168] *See, e.g.*, *Kadillak v. Commissioner*, 127 T.C. 184 (2006), *aff'd*, 534 F.3d 1197 (9th Cir. 2008); *Guzak v. United States*, 75 Fed. Cl. 304 (2007); *Chi Wai v. Commissioner*, T.C. Memo 2006-179. *See also Marcus v. Commissioner*, 129 T.C. 24 (2007) (difference between adjusted AMT basis and regular tax basis of stock received by ISO is not tax adjustment item in calculating alternative tax net operating loss (ATNOL) in year stock is sold; sale of stock received through exercise of ISOs is sale of capital asset and does not create ATNOL due to restrictions of §172(d)); *Merlo v. Commissioner*, 126 T.C. 205 (2006), *aff'd*, 492 F.3d 618 (5th Cir. 2007) (AMT income from ISOs computed on exercise date, not due date of return; capital loss from year of sale of underlying stock could not be carried back to eliminate AMT in exercise year); *In re Pavlosky*, 97 AFTR2d 2006-2916 (Bankr. S.D. Tex. 2006) (no "negative adjustment" provision applicable to individuals that counteracts the rule in §1211 limiting deduction of capital losses (net of capital gains) by individuals to $3,000 for AMT purposes), *aff'd*, No. 06-CV-2061, 2006 BL 188785 (S.D. Tex. 2006), *aff'd*, 256 Fed. App'x 690 (5th Cir. 2007). In addition, the IRS warned taxpayers in Notice 2004-28, against making frivolous claims for avoiding income tax or alternative minimum tax upon the exercise of stock options.

[169] The "AMT refundable credit amount" in any permitted tax year was the greater of (1) 50% of the "long-term unused minimum tax credit" for that year, or (2) the AMT refundable credit amount for the preceding tax year, determined without regard to the increase in credit under former §53(f)(2). Former §53(e)(2). A "long-term unused minimum tax credit" was defined as the portion of the minimum tax credit for any tax year attributable to the adjusted net minimum tax for tax years before the third tax year immediately preceding such tax year (assuming the credits are used on a first-in, first-out basis). Former §53(e)(3). The AMT refundable credit amount could not exceed the long-term unused minimum tax credit amount for that tax year. Former §53(e)(2)(A).

[170] Pub. L. No. 113-295.

[171] For further discussion of parachute payments, see 396 T.M., *Golden Parachutes*.

[172] Section 280G(b)(2)(B) also includes in the definition of parachute payment, "any payment in the nature of compensation to (or for the benefit of) a disqualified individual if such payment is made pursuant to an agreement which violates any generally enforced securities laws or regulations." This type of parachute payment is not discussed in this Portfolio.

[173] Reg. §1.280G-1, Q&A 15, 17.

[174] Reg. §1.280G-1, Q&A-13, Q&A-24(b), (c), and (f) *Exs.* 5–7.

[175] Reg. §1.280G-1, Q&A-13(a). *See also* PLR 9127016 (cashout of unvested ISOs would be treated as cashout of non-ISOs for purposes of determining whether optionees had received excess parachute payment). Rev. Proc. 2003-68, issued simultaneously with the release of the final golden parachute regulations (T.D. 9083, 68 Fed. Reg. 45,745 (Aug. 4, 2003)), provides guidance on valuing stock options for purposes of §280G and §4999. Rev. Proc. 2003-68 continues to allow the use of Black-Scholes and other valuation methods but provides flexibility to make certain adjustments for early terminations of employment or changes in volatility of stock price. Rev. Proc. 2003-68, §3.04, provides that there is an 18-month window after a change in ownership or control during which option values can be recalculated based upon changes in terms of employment or volatility of stock. However, Rev. Proc. 2003-68, §3.01, provides that the value of a stock option will not be considered properly determined if the option is valued solely by reference to the spread between the exercise price and the value at the time of change in ownership or control. *See also* unnumbered FSA dated Aug. 19, 1993 (cash payments on account of spread in ISOs upon change of control included in calculation of excess parachute payment determination); IRS Market Segment Specialization Program Guideline, Golden Parachute Audit Techniques Guide (Feb. 2005) (using value of options affected by change in control provisions without regard to whether they are ISOs or NSOs).

[176] §6331. For more information on levies, see 637 T.M., *Federal Tax Collection Procedure — Liens, Levies, Suits, and Third-Party Liability*.

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sel found that the levy extended to the options. The settlement agreement executed after the filing of the levy did not create a property right in the disputed options that would require subsequent levy but instead merely affirmed a property right already in existence.[177]

According to CCA 200926001, the restrictions on transfer of the options applicable to the taxpayer would not apply to the IRS and the statutory restrictions on the transferability of the ISOs under §422 are overridden by §6334(c), so the IRS can enforce the levy by selling the options to a third party. The Office of Chief Counsel made an analogy to the IRS's ability to levy on retirement benefits held in a qualified retirement plan. Under I.R.C. §401(a)(13) and ERISA §206(d), retirement plan assets can be used only to provide benefits to participants and their beneficiaries and cannot be alienated in favor of creditors. The IRS's rights of levy, however, override those restrictions on alienation.[178]

Practice Insight: In CCA 200926001, the employer was about to be acquired by another corporation, presumably creating a market for the IRS to sell the seized stock options. Most corporations, however, do not have an active market for trading their stock options, so the IRS may have limited opportunities for selling seized options in other situations.

CCA 200926001 did not address the tax consequences of seizing and selling ISOs.

For a discussion of the IRS's right to levy on nonqualified stock options, see 383 T.M., *Nonstatutory Stock Options.*

D. Impact on Employer

1. Grant, Assumption, or Exercise of Option

Just as an employee does not recognize taxable income on the grant or exercise of an ISO, an employer may not take a compensation deduction on the grant, assumption, or exercise of an ISO.[179] The amount paid by the employee to exercise the ISO will be considered the amount received by the employer for the transfer of the ISO stock.[180]

2. Disqualifying Dispositions

If the employee subsequently transfers ISO stock in a disqualifying disposition, the employer will be entitled to take a deduction from income in the employer's taxable year in which the disqualifying disposition occurs.[181] The employer may deduct an amount equal to the amount recognized by the employee as ordinary income due to the disqualifying disposition.[182] Accordingly, if the employee's ordinary income triggered by the disqualifying disposition is limited because the employee realizes an amount less than the fair market value of the ISO stock at the time of exercise, the employer may only deduct such lesser amount.[183]

Other limitations on the employer's deduction may apply. Unless an exception applies, §162(m) generally denies a deduction for "applicable employee remuneration" in excess of $1 million paid to a "covered employee" by a publicly traded corporation. Prior to the enactment of §13601 of the TCJA, §162(m) provided an exception for "performance-based compensation."[184]

If an optionee recognizes capital gain or loss on the exercise of an ISO, the employer is not entitled to a deduction, even for compensation not subject to §162(m) (such as compensation paid to an employee who is not a covered employee or where a covered employee's compensation does not exceed $1 million). However, under §162(m) prior to amendment by the TCJA,[185] where an employee recognized ordinary income upon the exercise of an option, and the employer followed the procedural requirements for performance-based compensation specified in IRS regulations,[186] the performance-based compensation exception generally applied, thereby allowing the employer a deduction with respect to the option exercise even for compensation subject to §162(m).[187]

Section 13601 of the TCJA also amended the definition of "covered employee" and various other provisions of §162(m).[188] Compensation provided pursuant to a written binding contract, which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date, receives legacy status and remains subject to the prior version of §162(m), including the performance-based compensation exception.[189] Conversely, if a covered employee recognizes ordinary income on the exercise of a stock option, and the amendments made by §13601 apply to the exercise (and the legacy treatment does not apply), then, unless the covered employee's total compensation is below $1 million or an exception applies, a publicly traded employer's deduction with respect to that exercise may be limited or eliminated by §162(m).

In its final regulations, Reg. §1.162-33, the IRS provided guidance on the amendments to §162(m) in the TCJA, including guidance on the definition of "written binding contract" and "material modification" for purposes of the legacy treatment.[190]

A full discussion of §162(m), and the amendments to §162(m) made by the TCJA, is beyond the scope of this Portfolio. Except as specifically noted, references throughout this Portfolio to the deduction for the employer merely take into consideration the deductions permitted by §83(h), §162 (other

[177] Property received after the notice of levy is served can be reached only by a subsequent levy. §6331(b). However, a levy on wages and salary is a continuous levy until the tax liability covered by the levy is satisfied or becomes unenforceable because of a lapse of time. §6331(e); Reg. §301.6331-1(b).

[178] *See, e.g.*, *McIntyre v. United States*, 222 F.3d 655 (9th Cir. 2000).

[179] §421(a)(2).

[180] §421(a)(3).

[181] It should be noted that if the employer is a subsidiary of the corporation issuing the ISO, the subsidiary is entitled to the deduction. *See* unnumbered FSA dated May 30, 1995.

[182] §421(b).

[183] §422(c)(2).

[184] §162(m) prior to amendment by the TCJA, Pub. L. No. 115-97, §13601.

[185] Pub. L. No. 115-97.

[186] Reg. §1.162-27(e).

[187] Reg. §1.162-27(e).

[188] The amendments made by TCJA §13601 are generally effective for taxable years of the employer beginning after December 31, 2017. Pub. L. No. 115-97, §13601(e)(1).

[189] Pub. L. No. 115-97, §13601(e)(2).

[190] Reg. §1.162-33, added by T.D. 9932, 85 Fed. Reg. 86,481 (Dec. 30, 2020), generally applicable to taxable years beginning on or after December 30, 2020, with the option for earlier applicability with respect to taxable years beginning after December 31, 2017. Special applicability dates apply to certain provisions. Taxpayers may no longer rely on the interim guidance of Notice 2018-68 for taxable years ending on or after December 20, 2019. 84 Fed. Reg. at 70,370.

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than §162(m)), and §421(b), and this Portfolio does not address deduction disallowance provisions such as §162(m) or requirements to capitalize, rather than deduct, compensation. For detailed discussions of these topics, see 390 T.M., *Reasonable Compensation.*

Practice Insight: At least two issues for the employer are not addressed by the regulations under §421 through §424: (1) the treatment of the exercise of an ISO and the subsequent disposition of the ISO shares for the purposes of computing the earnings and profits of the employer; and (2) the treatment of the exercise of an ISO and the subsequent disposition of the ISO shares for purposes of the employer's AMT. Arguably, earnings and profits should be reduced by the spread on the exercise of the ISO whether or not there is a disqualifying disposition.[191] If there is a later disqualifying disposition, the deduction allowed by the disqualifying disposition should not be a deduction from earnings and profits. The IRS, however, may contend that the deductibility treatment for regular tax purposes both as to the amount of the reduction (for example, the deduction may be less than the spread on exercise due to the application of §422(c)(2) and will be zero if there is no disqualifying disposition) and the timing of the reduction (for example, the deduction is allowed only in the year of a disqualifying disposition and not in the year of the exercise) should control the treatment for earnings and profits purposes.[192] The treatment of the exercise of an ISO for earnings and profits purposes can have special significance in the case of the employer's AMT calculations. The exercise of an ISO by an individual taxpayer may give rise to favorable AMT consequences for an employer.[193]

The exercise of an ISO (or NSO) may also have a favorable tax effect on an employer that has repurchased its own stock. Effective January 1, 2023, the Inflation Reduction Act imposes a 1% excise tax on the fair market value of stock of a "covered corporation" that is repurchased by the corporation.[194] A "covered corporation" is any domestic corporation with stock traded on an established securities market.[195] In determining the amount of the excise tax, the fair market value of stock repurchased by the corporation during a year is reduced by the fair market value of stock issued by the corporation during the year, including stock issued or provided to employees, whether through exercise of an option or otherwise.[196]

Note: Accordingly, if a covered corporation repurchases stock during a year, the exercise of ISOs and NSOs by employees during that year will generally reduce the amount of the excise tax owed with respect to the repurchases.

3. Withholding

When an employee recognizes ordinary income upon exercise of an *NSO*, the employer must withhold for purposes of federal income taxes as well as for FICA[197] and must include such compensation in wages for purposes of FUTA.[198] *ISOs*, however, are accorded different treatment.

Section 3121(a)(22) excludes from wages for FICA purposes the income on account of the transfer of stock pursuant to the exercise of statutory stock options or any disposition of such stock, and §3306(b)(19)[199] excludes such income from wages for FUTA purposes. Federal income tax withholding also is not required on disqualifying dispositions.[200] Thus, no federal employment taxes are imposed upon the exercise of statutory stock options or disposition of the stock after the exercise of statutory stock options, and no federal withholding is required.

Practice Insight: Individual taxpayers must continue to include compensation in income relating to the disposition of stock acquired pursuant to an option exercise, which may have to be included in estimated tax.

4. Reporting Considerations

a. Background

Section 6039 imposes reporting requirements on corporations issuing stock on exercise of ISOs.[201] Every corporation that issues stock upon the exercise of an ISO must (i) file an information return with the IRS and (ii) furnish a statement including such information to the employee who exercised the ISO.[202] These reporting obligations are in addition to the Form W-2 reporting obligations that arise upon the disqualifying disposition of stock acquired under an ISO. Corporations are exempt from the information return requirements with respect to any nonresident aliens (as defined in §7701(b)) for whom the corporation was not required to issue a Form W-2 for any calendar year within the period beginning with the first day of the calendar year in which the ISO was granted and ending on the last day of the calendar year in which the ISO was exercised.[203]

b. IRS Information Return

A corporation that transfers stock pursuant to an individual's exercise of an ISO is required to file a Form 3921, *Exer-*

[191] *See Divine v. Commissioner*, 500 F.2d 1041 (2d Cir. 1974); *Luckman v. Commissioner*, 418 F.2d 381 (7th Cir. 1970).

[192] *See, e.g.*, Reg. §1.312-6(a).

[193] *See* Willens, *Options Can Reduce Corporate AMT Obligations*, 16 Daily Tax Rep. J-1 (Jan. 28, 2009). For further discussion of corporate AMT issues, see 752 T.M., *Corporate Alternative Minimum Tax.*

[194] §4501, as added by the Inflation Reduction Act, Pub. L. No. 117-169, §10201, effective for taxable years beginning after December 31, 2022. For further discussion of this excise tax, including the reporting and payment rules, see 767 T.M., *Redemptions.*

[195] §4501(b), as added by Pub. L. No. 117-169. Certain acquisitions of stock of the covered corporation by a "specified affiliate" of the covered corporation are treated as repurchases by the covered corporation.

[196] §4501(c)(3), as added by Pub. L. No. 117-169.

[197] Federal Insurance Contributions Act, §3101 *et seq. See* Generic Legal Advice Memorandum 2020-004 (May 20, 2020). Also, effective January 1, 2017, Accounting Standards Update (ASU) 2016-09 amends FASB ASC 718-10-25-18 and allows entities to withhold an amount up to the employees' *maximum individual tax* rate in the relevant jurisdiction(s) without triggering unfavorable accounting treatment. This change, however, is not mandatory, and many employers have elected to not change their withholding practices.

[198] Federal Unemployment Tax Act, §3301 *et seq.*

[199] *See also* §3231(e)(12) (railroad retirement tax exclusion); §209(a)(19) of the Social Security Act (Social Security benefits exclusion). In *Wis. Cent. Ltd. v. United States*, 138 S. Ct. 2067 (2018), the Court held that income from nonqualified stock options is also not taxable "compensation" under the Railroad Retirement Tax Act because it is not "money remuneration" within the meaning of the Act.

[200] §421(b).

[201] §6039(a)(1), §6039(b); Reg. §1.6039-1(a), §1.6039-2(a).

[202] §6039(a)(1), §6039(b); Reg. §1.6039-1(a), §1.6039-2(a).

[203] Reg. §1.6039-1(e).

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cise of an Incentive Stock Option Under Section 422(b), with the IRS for that calendar year on or before February 28 of the following year (or March 31 if filing electronically).[204] An automatic 30-day filing extension is available by filing Form 8809, and an additional 30-day extension may be requested.[205]

Corporations may satisfy the information return requirement by submitting a substitute Form 3921 in accordance with the guidelines set forth in IRS Pub. 1179 (or its designated successor).[206] If an employer fails to file the IRS information return, penalties may be assessed under §6721.[207]

Information returns required to be filed on or after January 1, 2024, must be filed electronically by any person that is required to file 10 or more information returns in that calendar year.[208] All information returns listed in Reg. §301.6011-2(b)(1) and Reg. §301.6011-2(b)(2), including Forms 3921, 3922, and W-2, are aggregated in determining whether a person is required to file 10 or more information returns in a calendar year.[209] In calendar years beginning before 2024, any person that is required to file 250 or more Forms 3921 during the calendar year must file those returns electronically. Persons may ask the IRS to waive the electronic filing by filing Form 8508, *Application for a Waiver from Electronic Filing of Information Returns*.[210]

As of September 26, 2021, all requests for authorization to file Form 3921 electronically through the Filing Information Returns Electronically (FIRE) System are made using the online Information Returns (IR) Application for Transmitter Control Code (TCC), available on the Filing Information Returns Electronically (FIRE) page on IRS.gov. Prior to that, persons submitted Form 4419, *Application for Filing Information Returns Electronically (FIRE)*, to request authorization to file Form 3921 electronically through the FIRE system.

c. Employee Information Statement

A corporation that is required to file a Form 3921 must also file an information statement with each employee named in that return.[211] Employers can meet this requirement by sending Copy B of the Form 3921 to the employee.[212]

The statement must be furnished on or before January 31 of the year following the year in which the ISO exercise occurs.[213] An extension of time to furnish the information statement may be granted by the IRS for an additional 30 days if good cause is shown.[214] If the employer fails to furnish any such statement, penalties may be assessed under §6722.[215] If the employee does not take legal title upon exercise of the ISO but directs the agent holding the stock to transfer legal title to another party (e.g., a bona fide purchaser), the corporation must furnish the employee information statement to the employee who exercised the ISO.

Employee information statements must be delivered in person or mailed to the recipient's last known address. They may be delivered electronically if the recipient properly consents to such a means of delivery.[216]

d. Employer's Reporting Responsibilities on Form W-2

The IRS generally requires that ordinary income resulting from a disqualifying disposition of stock acquired pursuant to the exercise of an ISO be reported in Box 1 of Form W-2.[217]

Practice Insight: Reporting the income in Box 1 from a disqualifying disposition of stock is not in the instructions to the Form W-2.[218]

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[204] §6039(a); Reg. §1.6039-1(a)(2), §1.6039-1(c). Instructions to Forms 3921 and 3922; Part C of the IRS General Instructions for Certain Information Returns.

[205] Reg. §1.6081-8(a), as amended by T.D. 9838, 83 Fed. Reg. 38,023 (Aug. 3, 2018), applying to requests for extensions of time to file information returns required to be filed after December 31, 2018; former Reg. §1.6081-8T(a), applying to extensions of time to file information returns due after December 31, 2016, and required to be filed before January 1, 2019.

[206] Preamble to T.D. 9470, 74 Fed. Reg. 59,087, 59,090 (Nov. 17, 2009).

[207] Reg. §1.6039-1(d).

[208] Reg. §301.6011-2(c)(1) and §301.6011-2(g), as amended by T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023).

[209] Reg. §301.6011-2(c)(4), as amended by T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023). Form 3921 was added to Reg. §301.6011-2(b)(1) in T.D. 9972.

[210] Form 8508 lists permissible justifications for waiver, including undue financial hardship. However, Treasury and IRS have stated that based on the sophistication of filers of Forms 3921, and the accessibility and availability of electronic filing, these filers are unlikely to incur unreasonable costs to electronically file these returns. Preamble to REG-102951-16, 86 Fed. Reg. 39,910, 39,913 (July 23, 2021) (proposed rules finalized in T.D. 9972).

[211] §6039(b).

[212] Part M of theIRS General Instructions for Certain Information Returns. Corporations may also satisfy the employee information statement requirement by submitting substitute Forms 3921 in accordance with guidelines set forth in IRS Pub. 1179 (or its designated successor). *Id.*; preamble to T.D. 9470, 74 Fed. Reg. 59,087, 59,090 (Nov. 17, 2009).

[213] §6039(b); Reg. §1.6039-2(c)(1); Part M of the IRS General Instructions for Certain Information Returns. If the statement is furnished in a consolidated reporting statement under §6045, it is due by February 15. *Id.*

[214] Reg. §1.6039-2(c)(2) (extensions of time may be granted in accordance with instructions to Form 3921); Part M of the IRS General Instructions for Certain Information Returns.

[215] Reg. §1.6039-2(d).

[216] Part M of the IRS General Instructions for Certain Information Returns. Consent to electronic delivery must be obtained by following the requirements under Reg. §31.6051-1(j)(2)(i), which requires, among other things, that an individual affirmatively consents in a manner that demonstrates that the individual can access the same electronic format in which the §6039 notices will be furnished.

[217] IRS Pub. 15-B. In addition, in Notice 2002-47, the IRS noted that Reg. §1.6041-2(a)(1) requires reporting of a payment made by an employer to an employee on Form W-2, even if the payment is not subject to income tax withholding, if the total amount of the payment and any other payment of remuneration (including wages, if any) made to the employee (or former employee) that are required to be reported on Form W-2 aggregate at least $600 in a calendar year. Therefore, the IRS advised, a disqualifying disposition of stock acquired pursuant to the exercise of a statutory stock option which results in ordinary income generally will result in a reporting obligation on Form W-2. The payment threshold is $2,000 for payments made after December 31, 2025, and that amount is adjusted annually after 2026. §6041(a), as amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70433(a), §6041(h), added by OBBBA, Pub. L. No. 119-21, §70433(b).

[218] The only similar reference in the General Instructions for Forms W-2 and W-3 is to NSOs, but the W-2 Instructions note that the reporting requirement for NSOs does not apply to the exercise of a statutory stock option, or the sale or disposition of stock acquired pursuant to the exercise of a statutory stock options. The instructions also refer taxpayers to Pub. 15-B for more information about the taxability of employee stock options. Pub. 15-B refers the reader to §421, §422, and §423 for more information about employee stock options; therefore, §422(c)(2) should be applied for purposes of Form W-2 reporting if the employee realizes an amount less than the fair market value of the ISO stock at the time of exercise and if a loss if realized would be recognized.

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e. Condition for Allowance of Compensation Deduction — Compliance with Reporting Requirements

Although an employer is not obligated to withhold upon a disqualifying disposition of ISO stock, the availability of the employer's deduction is predicated upon the satisfaction of certain reporting obligations.[219] Reg. §1.421-2(b)(1)(i) provides that "the amount allowed as a deduction must be determined as if the requirements of §83(h) and §1.83-6(a) apply." Reg. §1.83-6(a)(1) in turn provides that the amount of the deduction is equal to the amount included as compensation in the gross income of the employee.

Even if the employee does not include the appropriate amount in income, however, if the employer timely complies with applicable Form W-2 reporting requirements under §6041 or §6041A with respect to the amount includible in the employee's income, the employee will be deemed to have included such amount in gross income for purposes of the employer's right to a deduction. This "deemed inclusion rule" allows the deduction without requiring the employer to demonstrate actual income inclusion by the employee.[220] Moreover, if, in the course of preparing its return, the employer discovers that it did not properly include the amount of ordinary income on the employee's Form W-2, a special rule in the regulations under §83 provides that the employer will be considered to have timely complied with applicable W-2 reporting requirements if the employer prepares, files and furnishes to the employee or former employee the Form W-2 (or an amended Form W-2c) on or before the date on which the employer files its tax return (including an amended return) claiming a deduction relating to the disqualifying disposition.[221]

5. Status of Deduction for Other Purposes

In *Sun Microsystems, Inc. v. Commissioner*,[222] the Tax Court considered whether income realized from disqualifying dispositions of stock purchased through an ISO plan were wages for purposes of the §41 credit for increasing research activities.[223] In computing its credit under §41, the employer in *Sun Microsystems* included as wages the spread income (which the court defined as "the difference between the fair market value of the shares on the date of exercise (or the sale price, if lower) and the amount paid for the shares") with respect to the ISO stock of employees who engaged in disqualifying dispositions. The employer also included as wages the spread income from disqualifying dispositions of stock acquired through an employee stock purchase plan and the spread income from the exercise of NSOs. The IRS stipulated that the spread income from the exercise of NSOs and from the disqualifying dispositions of the stock from the employee stock purchase plan constituted wages for this purpose. Further, the IRS agreed that the disqualifying dispositions of the ISO stock generated ordinary income, but the parties disagreed on whether such ordinary income should be considered wages under §41 and §3401(a). The taxpayer relied on *Apple Computer, Inc. v. Commissioner*,[224] in which the court held that the spread resulting from the exercise of an NSO, which constitutes income under §83, was wages for purposes of §3401 and for purposes of the credit under former §44F, the predecessor of §41. The Tax Court held that ISO disqualifying dispositions were equivalent to dispositions of NSOs for purposes of the recognition of income and the §162 deduction and, therefore, such amounts constituted wages for purposes of §3401(a) (and, in turn, for purposes of the §41 credit). The IRS acquiesced in *Sun Microsystems*.[225]

In FAA 20094301F, a field counsel office in the IRS Office of Chief Counsel denied an employer a deduction under §174, which provides a deduction for certain research and experimental expenditures, in connection with the exercise of incentive stock options held by employees performing research and development activities, when there was no disqualifying disposition. The employer argued that a deduction under §174 was permitted because §421(a)(1) specifically disallows a deduction only under §162 for compensation attributable to a stock option granted under §422 or §423 (except in the case of disqualifying dispositions) and does not reference any other sections of the Code. The field counsel memorandum advised that: (1) the legislative history of §174 supports a deduction of research and experimental expenditures that would otherwise be capitalized but indicates §174 was not intended to alter the treatment of incentive stock options; and (2) §421 does not permit a deduction for exercised incentive stock options under §174. The memorandum reasoned that the "spread" (the amount by which the fair market value of the stock transferred exceeds the amount the employee paid for such stock) does not qualify as an "expenditure" under §174 and that an employer may deduct the compensatory element attributable to an incentive stock option under only one circumstance — if the employee disposes of the stock in a disqualifying disposition, citing §421(b). A plain reading of §421 to permit a deduction under §174 is, the memorandum claimed, disingenuous because this position violates the legislative history and congressional policy of §421 that the employer may deduct the compensatory element of a stock option only if the compensatory element is included in the gross income of the employee.[226] It is unclear if

[219] In the case of a qualifying disposition, however, the corporation is not required to report the gain and is not entitled to a tax deduction. *See* II.D.3., above.

[220] Reg. §1.83-6(a); T.D. 8599, 60 Fed. Reg. 36,995–36,996 (July 19, 1995).

[221] Reg. §1.83-6(a)(2).

[222] T.C. Memo 1995-69, *acq.*, 1997-2 C.B. 1.

[223] Section 41 uses the same definition of wages as that used in §3401(a) for income tax withholding purposes. §41(b)(2)(D)(i).

[224] 98 T.C. 232 (1992), *acq.*, 1992-2 C.B. 1.

[225] 1997-2 C.B. 1; AOD 1997-10. The IRS later issued an internal memorandum calling for the imposition of employment taxes on the spread at the time an ISO is exercised and federal income tax withholding on the spread upon a disqualifying disposition. In 2002, however, the IRS imposed a moratorium on the agency's pending guidance on the imposition of employment taxes and withholding obligations upon the exercise of a statutory stock option or the disposition of the stock after the exercise of such an option. Notice 2002-47. The American Jobs Creation Act of 2004 (AJCA) codified this result by providing that income from the exercise of an ISO was not wages for purposes of the FICA or FUTA taxes and that no amount need be withheld with respect to compensation income from such a disqualifying disposition. §3121(a)(22), §421(b). *See also* II.D.3., above. These AJCA provisions did not, however, amend the definition of wages in §3401(a) and there is no indication that Congress intended the AJCA provisions to affect the result in *Sun Microsystems.*

[226] For an analysis that reaches an opposite conclusion from the IRS's advice in FAA 20094301F, see Willens, *IRS Takes Hard Line in Ruling 'Compensatory Element' of an ISO Never Deductible*, 16 Daily Tax Rep. J-1 (Nov. 16, 2009). Willens argues that only deductions under §162 are barred with re-

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the National Office of IRS Chief Counsel would agree with this analysis.

For amounts paid or incurred in taxable years beginning after December 31, 2021,[227] and paid or incurred in taxable years beginning before January 1, 2025, taxpayers generally are not allowed a deduction, but instead must capitalize and amortize such expenditures over a 5-year period (15 years if attributable to research outside the United States).[228] For amounts paid or incurred in taxable years beginning after December 31, 2024, taxpayers may deduct any domestic research or experimental expenditures paid or incurred during the taxable year.[229] However, taxpayers generally must capitalize and amortize expenditures over a 15-year period if attributable to research outside the United States.[230]

E. Other Methods of Exercise

An ISO plan may also contain provisions that are not specifically required under §422. Such provisions may include ways in which the employee can finance the exercise price of the ISOs.

1. Use of Stock for Option Exercise Price

a. Practical Uses of Stock in ISO Exercise

An ISO plan may provide that the employee may pay for the exercise of the employee's options by tendering stock of the employer corporation that the employee already owns.[231] Such a transaction is commonly referred to as a "stock swap."[232] Traditionally, in ISO plans, one of the basic requirements of a stock swap was that the shares used in the exercise satisfy one of the following two criteria: (1) the shares used in the exercise must have been held for the requisite period (usually six months) necessary to avoid a charge to the corporation's earnings for financial accounting purposes; or (2) the shares used in the exercise were not originally acquired from the corporation, either directly or indirectly. As a result of changes in the applicable accounting rules, such restrictions are no longer necessary to avoid adverse accounting consequences. Similar restrictions may be retained, however, to encourage the holding of corporation stock by the employees.

The use of appreciated stock to pay the exercise price of an ISO is advantageous to the employee because the employee will not be required to recognize any of the built-in gain in the appreciated stock surrendered in the stock swap. The general tax principle permitting this treatment of appreciated stock is set forth in §1036, which permits an exchange of common stock for common stock of the same issuer (or preferred stock for preferred stock of the same issuer) to qualify for nonrecognition treatment.

The required treatment of basis and holding period of stock acquired under an ISO using stock as consideration is as follows:

- The optionee's basis in the ISO shares received in the §1036 exchange is the same as the optionee's basis in the shares surrendered in the exchange, increased, if applicable, by any amount included in gross income as compensation under §421 through §424 or §83.[233] For purposes of Reg. §1.422-1 and §83 and §421(b) and the regulations thereunder, the amount paid for the shares purchased under the option is the fair market value of the shares surrendered on the date of the exchange.[234] Except for purposes of Reg. §1.422-1(a) (relating to disqualifying dispositions), the holding period of the shares is determined under §1223.[235]

- The optionee's basis in the ISO shares not received pursuant to the §1036 exchange (i.e., the shares representing the spread on exercise (the "spread shares")) is zero.[236] For all purposes, the holding period of the spread shares begins as of the date on which the spread shares are transferred to the optionee.[237] For purposes of Reg. §1.422-1(b) and §83 and §421(b) and the regulations thereunder, the amount paid for the spread shares is considered to be zero.[238]

Example: B, an employee of X Corp., owns 1,000 shares of X Corp. stock having a basis of $10 per share that B purchased on the open market. B also holds an ISO to purchase 500 shares of X Corp. stock, with an exercise price of $15 per share. B decides to exercise the entire ISO when the fair market value of X Corp. stock is $20. X Corp.'s ISO plan provides that stock of X Corp. may be used to pay the ISO exercise price. B tenders 375 shares of B's already owned X Corp. stock to X Corp. as payment of the total ISO exercise price of $7,500. B recognizes no taxable income on either the transfer of the stock to exercise the ISO or upon the exercise of the ISO. B's basis in 375 of the ISO shares ("exercise shares") will be $10 per share, and B will have a zero basis in the remaining 125 ISO shares (i.e., the spread shares).

spect to the compensatory element of an incentive stock option and that the IRS's reliance on the legislative history of §421 is improper because §421(a)(2) is clear and unambiguous on its face. *See also* Coughlan, *Section 174 R&E Deduction Upon Statutory Stock Option Exercise*, 58 Tax Law. 435 (2005).

[227] Pub. L. No. 115-97, §13206(e).

[228] §174, as amended by Pub. L. No. 115-97, §13206, and before amendment by OBBBA, Pub. L. No. 119-21, §70302.

[229] §174A, added by OBBBA, Pub. L. No. 119-21, §70302(a), generally effective for amounts paid or incurred in taxable years beginning after December 31, 2024. For a more in-depth analysis of research and experimental expenditures see 556 T.M., *Research and Developmental Expenditures.*

[230] §174, as amended by OBBBA, Pub. L. No. 119-21, §70302(b)(1), generally effective for amounts paid or incurred in taxable years beginning after December 31, 2024.

[231] §422(c)(4)(A).

[232] The regulations, however, refer to this method of exercise as a "cashless exercise." *See* Reg. §1.422-5(b). Although the IRS label is more descriptive, the term "stock swap" is more commonly used by option administrators to refer to an exercise of an option and the simultaneous sale of the shares pursuant to a procedure authorized by Regulation T of the Federal Reserve Board (12 C.F.R. §220.3(e)(4)). In order to avoid adding to the confusion, this Portfolio will use the term "stock swap."

[233] Reg. §1.422-5(b)(3)(i).

[234] Reg. §1.422-5(b)(3)(i).

[235] Reg. §1.422-5(b)(3)(i).

[236] Reg. §1.422-5(b)(3)(ii).

[237] Reg. §1.422-5(b)(3)(ii).

[238] Reg. §1.422-5(b)(3)(ii). *See also* Rev. Rul. 80-244 (applying these principles to the exercise of nonqualified stock options using shares acquired through nonqualified stock options).

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If either the exercise shares or the spread shares are disposed of during the period when a disposition will be a disqualifying disposition, the shares with the lowest basis (i.e., the spread shares) are deemed to be disposed of first.[239] In the above example, if B were to sell 200 of the ISO shares, 125 of the shares sold would be the spread shares, and 75 of the shares would be the exercise shares, regardless of any attempt to specifically identify that all of the 200 shares were exercise shares.

In order to exercise an ISO by means of a stock swap, an optionee need not actually physically surrender previously owned shares. Payment of the exercise price of an ISO by the constructive delivery of shares acquired through the prior exercise of ISOs that have been held for the requisite holding period under §422(a) or with shares acquired by some other means (such as through the exercise of NSOs or purchase on the open market) will have the same result as the physical surrender of ISO shares that have been held for the requisite period.[240] The method for constructive payment of the ISO exercise price with corporation stock is commonly referred to as "attestation."

If such pre-owned shares are held by a registered securities broker on behalf of the optionee, the employer that issued the ISO may require the broker to provide a statement attesting to the employee's ownership of the number of shares that are intended to be used to pay the ISO exercise price. If the optionee actually holds corporation stock certificates, the optionee would provide such a statement. Upon receipt of such a statement, the corporation would treat such shares as constructively exchanged and issue to the optionee (or the broker, if appropriate) a certificate for the net number of shares, i.e., the number of shares subject to the ISO exercise minus the number of shares used to pay for the exercise through the constructive delivery.

Under §424(c)(3), if shares that were previously acquired through the exercise of an ISO but have not been held for the period required to avoid a disqualifying disposition are surrendered in a stock swap, the surrender will constitute a disqualifying disposition requiring recognition of ordinary income under §421(b). If the shares being surrendered have declined in value, §422(c)(2) may not be available to limit the amount of ordinary income recognized because the shares used to exercise the ISO are being surrendered in a transaction that would generally be covered by §1036 so that a loss (if sustained) would not be recognized. While §424(c)(3)(A) provides that §1036 does not apply in this situation, it is not clear if this means that, for purposes of §422(c)(2), the surrender of the shares is treated as a disposition with respect to which a loss (if sustained) would be recognized, so that §422(c)(2) would limit the recognition of ordinary income. If the shares being surrendered have increased in value, the additional appreciation in the value of the stock that is not taxed as ordinary income under the disqualifying disposition rules will be subject to nonrecognition under §1036.[241] Any additional shares actually received will have a basis equal to the amount of cash paid, if any, to exercise the ISO.[242] The optionee will not recognize income on receipt of the new shares as a result of the exercise of the ISO.[243] An optionee who constructively pays the exercise price of an ISO with shares that were previously acquired through the exercise of an ISO but have not met the holding period requirements of §422(a) will receive the same tax treatment as an optionee who physically surrenders shares that do not meet the holding period requirements.[244]

Example: Assume the same facts as in the previous example, except that B received the 1,000 shares that were already owned from the exercise of an ISO granted 18 months previously. The use of the 375 shares of previously acquired ISO stock is a disqualifying disposition. B will be required to recognize compensation on the bargain purchase element of the 375 shares used in the ISO exercise.

If the previously acquired shares were held by a registered securities broker in street name, two private letter rulings[245] stated that the optionee had to provide the employer with a notarized statement attesting to the number of shares owned that were intended to be used to exercise the options. The IRS has relaxed the requirement for notarized attestation of shares intended to be used for exercising ISOs to allow paperless exercises of stock options. PLR 200207005 approved the paperless exercise of ISOs over an employer's local area network; the optionee only had to attest to such facts in an e-mail sent to the employer. In PLR 200207005, the employer allowed optionees to exercise their options with previously acquired stock and proposed procedures under which the optionees could use the employer's local area network to exercise options by use of a constructive exchange of the previously acquired shares instead of actually tendering the shares to the corporation. Under this constructive exchange, if the optionee's previously acquired shares were held for the optionee by a registered securities broker in a street name, the optionee would send the employer an e-mail attesting to the specific number of those shares intended to be used to exercise the options. If the optionee actually held the stock certificates for the shares, the optionee would send an e-mail message containing the certificate numbers of the shares intended to be used to exercise the options. When the employer received the e-mail, with either the attestation or the certificate numbers, the employer would treat the previously acquired shares as having been constructively delivered in payment of the exercise price.

b. Stock Pyramiding

Stock pyramiding, a type of stock swap, refers to the tender of pre-owned shares (or, in some cases, a small amount of cash) in order to exercise an option in a series of interrelated transactions that results in the optionee receiving a net increase in the number of the issuer's shares the optionee holds. In the ISO context, stock pyramiding can violate the holding period requirement under §422(a) and thus result in a disqualify-

[239] Reg. §1.422-5(b)(2).
[240] *See* PLR 200207005, PLR 9736040, PLR 9629028.
[241] *See* Reg. §1.422-5(e) *Ex.* 3.
[242] §424(c)(3), §1012.
[243] §421(a), §422(a).
[244] *See* PLR 200207005, PLR 9736040, PLR 9629028.
[245] PLR 9736040, PLR 9629028.

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ing disposition if the holding period requirements for such ISO stock have not been met at the time of exercise.[246]

Example: B, an employee of X Corp., exercises an ISO ("first ISO") to purchase 100 shares of X Corp. stock at $10 per share when the price of X Corp. stock is $15 per share. Five months later, when the price of X Corp. stock is $30 per share, B decides to exercise a second ISO to purchase 1,000 shares of X Corp. stock with an exercise price of $15 per share ($15,000 total exercise price). In Step 1, B first tenders the 100 previously acquired shares, each of which now has a value of $30, as payment for 200 shares under the second ISO (100 shares at $30 per share = $3,000 = exercise price for 200 shares under the second ISO at $15 per share). B receives the 200 shares. In Step 2, B tenders the 200 shares received in Step 1 under the second ISO as payment for the exercise price of 400 of the shares remaining under the second ISO (200 shares at $30 per share = $6,000 = exercise price for 400 shares under the second ISO at $15 per share). B receives 400 shares covered by the second ISO. After this transaction, B has exercised a total of 600 of the 1,000 shares covered by the second ISO; only 400 shares remain unexercised under the second ISO at a total exercise price of $6,000. In Step 3, B tenders 200 of the 400 shares B now holds as a result of the previous transactions in order to pay the exercise price of the 400 remaining shares under the second ISO (200 shares at $30 per share = $6,000 = the exercise price for 400 shares under the second ISO at $15 per share). B receives an additional 400 shares covered by the second ISO; these shares, when combined with the 200 shares B still holds as a result of Step 2, equal 600 shares. The second ISO has now been fully exercised. Because the 500 ISO shares that were surrendered to exercise the second ISO were not held for the necessary holding period, the surrender of such shares triggers disqualifying dispositions. Accordingly, B recognizes $500 of ordinary income with respect to the 100 shares from the first ISO and $6,000 of ordinary income with respect to the 400 shares from the second ISO that were used to exercise the second ISO. The accuracy of the calculations can be demonstrated by observing that immediately before Step 1, B had $18,000 of value (i.e., 100 shares at $30 per share plus an option for 1,000 shares with a spread of $15 per share). Immediately after Step 3, B has $18,000 of value (i.e., 600 shares at $30 per share).

The result in the above Example is dictated by the requirements of Reg. §1.422-5(b)(3)(i) and §1.422-5(b)(3)(ii), discussed in II.E.1.a., above. It should be noted that the foregoing discussion of stock pyramiding assumes the separate steps will be respected for tax purposes. If the separate steps are accomplished in a manner that results in the separate steps being disregarded, such an exercise may be treated as the exercise of a stock-settled stock appreciation right rather than the exercise of an ISO. If so treated, the employer will be required to withhold upon the exercise, and the employee will recognize ordinary income on the entire spread on exercise of the option rather than merely the spread on exercise with respect to the surrendered shares.

c. Reload Options

In the above Example, immediately before Step 1, B held 100 shares of stock and options for 1,000 shares. Once B was finished exercising the second ISO, B held 600 shares. While the value of what B held immediately before Step 1 was $18,000 and the value of what B held immediately after Step 3 was also $18,000, B has reduced B's total exposure to the corporation's stock from 1,100 shares to 600 shares. This effect may conflict with the corporation's objective of increasing employee stock ownership. Reload options have been designed to address this problem. A reload option typically provides for the automatic grant of a new option if an employee uses corporation stock to pay the exercise price of an existing option. The reload option will be granted for the same number of shares as were used to pay the exercise price of the original ISO and will have an exercise price equal to the fair market value of the corporation's stock on the date of the grant of the reload option (i.e., on the date the employee exercises the original ISO). This additional option grant gives the employee the potential to realize further appreciation of the corporation's stock after the exercise of the employee's original ISO and can help achieve the corporation's objective of maximizing the employee's stockholdings.

2. Option Subject to a Condition

An ISO may be subject to a condition, or grant a right, that is not inconsistent with ISO requirements under the regulations. An option that includes an alternative right is not an ISO if the ISO requirements are effectively avoided by the exercise of the alternative right. For example, an alternative right extending the option term beyond 10 years, setting an option price below fair market value, or permitting transferability prevents an option from qualifying as an ISO. If either of two options can be exercised, but not both, each such option is a disqualifying alternative right with respect to the other, even though one or both options would individually satisfy the ISO requirements under the regulations.[247] An alternative right to receive a taxable payment of cash and/or property in exchange for the cancellation or surrender of the option does not disqualify the option as an ISO if: (1) the right is exercisable only when the then fair market value of the stock exceeds the exercise price of the option and the option is otherwise exercisable; (2) the right is transferable only when the option is otherwise transferable; and (3) the exercise of the right has economic and tax consequences no more favorable than the exercise of the option followed by an immediate sale of the stock.[248] For this purpose, the exercise of the alternative right does not have the same economic and tax consequences if the payment exceeds the differ-

[246] §424(c)(3). This is to be contrasted with the exercise of an NSO using ISO stock, in which a failure of the ISO shares to meet the ISO holding period does not result in a disqualifying disposition. Rev. Rul. 80-244. *See also* PLR 9736040, PLR 9629028. The regulations preserve this distinction in the treatments of using insufficiently aged ISO stock as consideration to exercise an ISO (where it is a disqualifying disposition, see Reg. §1.422-5(e) *Ex.* 3) versus to exercise an NSO (where it is not a disqualifying disposition; see Reg. §1.422-5(e) *Ex.* 4).

[247] Reg. §1.422-5(d)(2).

[248] Reg. §1.422-5(d)(3).

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ence between the then fair market value of the stock and the option's exercise price.[249]

3. Stock Appreciation Rights

Another method that corporations may use to enable employees to benefit from increases in the value of the corporation's stock without the outlay of cash, or to receive cash that may be used to pay the exercise price of options, is the grant of stock appreciation rights (SARs). On exercise, a SAR entitles an employee to receive an amount equal to the spread between the fair market value of the corporation's stock on the date of grant of the SAR and the stock's fair market value on the date of exercise of the SAR. The SAR may be paid in either cash or property, such as corporate stock. If cash is given upon exercise of the SAR, the employee is taxed currently upon the receipt of that cash. If property is given upon the exercise of the SAR, the rules of §83 apply. Consequently, for example, payment of a SAR in corporate stock that is not transferable and is subject to substantial risk of forfeiture (such as a vesting schedule) will not be included in the employee's taxable income until the employee vests in the stock (or it becomes transferable).

An ISO plan may provide for SARs to be issued that are not in conjunction with the grant of an ISO. An ISO plan may also provide that ISOs and SARs are issued together such that either (1) the exercise of one is automatic upon the exercise of the other, or (2) if the employee exercises the ISO, the corresponding number of shares underlying the SAR is automatically reduced (and vice versa). When the exercise of the ISO eliminates the ability to exercise the SAR or, conversely, when the exercise of the SAR eliminates the ability to exercise the ISO, the ISO and the SAR are said to be issued in "tandem." Tandem ISO-SARs are permissible as alternative rights.[250]

Example: On December 31, 2019, X Corp. grants to B 100 tandem ISO/SARs either to purchase one share of X Corp. stock at $10 per share (the fair market value of X Corp. stock on December 31, 2019) or to receive the difference between the fair market value of a share of X Corp. stock at the time of exercise and $10. When the fair market value of X Corp. stock is $15 per share, B may either exercise the ISOs by paying the exercise price of $10 per share and receiving a share of stock worth $15 or exercise the SARs without any current cash outlay and receive $5 in cash for every SAR exercised. If B exercises 75 SARs on December 31, 2020, B will have only 25 of the original tandem ISO/SARs still available. In this example, X Corp. would be required to withhold upon the exercise of the SAR. Accordingly, B would not, in fact, receive the full $375 (i.e., $5 times 75 shares) in cash upon the exercise of the SAR as a portion of such cash would be withheld for applicable taxes.

Section 422(c)(4) allows an option that otherwise qualifies as an ISO to be treated as an ISO even if the employee has a right to receive property at the time of exercise of the option or if the option is subject to any condition not inconsistent with the ISO requirements of §422(b). Accordingly, the optionee may be given the right to receive additional compensation, in cash or property, when the option is exercised, provided such additional compensation is includible in income under §61 or §83. The amount of such additional compensation may be determined in any manner, including by reference to the fair market value of the stock at the time of exercise or to the option price.[251]

Practice Insight: An interesting question arises as how to characterize an option intended to be an ISO that permits as one of its methods of exercise that it be "net exercised" (i.e., that the option can be exercised by surrendering the option in exchange for shares with a value equal to the excess of the value of the stock subject to the option over the exercise price). In effect, such an exercise is equivalent to the exercise of a stock-settled SAR. One possibility would be to treat such an option as an ISO with a tandem SAR. Under this approach, if the ISO is exercised in a manner other than being net exercised, the exercise will be treated as the exercise of an ISO. If the option is exercised via the net exercise method, however, it will be treated as the exercise of a SAR under §83 and not the exercise of an ISO. Another possibility would be to view the net exercise feature as a permissible manner of exercise of an ISO by analogy to the stock pyramiding discussion in II.E.1.b., above. The IRS, however, might view such an option as containing an impermissible provision that disqualifies the option from being treated as an ISO regardless of the manner of exercise.[252]

4. Same-Day Sales

Another method that assists employees in financing the exercise of options for employer stock is a same-day sale program (also known as "cashless exercise" program, but not to be confused with a stock swap as discussed in II.E.1.a., above). Under such a program, an employee who wishes to exercise options will contact a broker who will, as an advance to the employee, remit the option exercise price to the corporation. Upon receipt of the shares, the broker will sell enough shares to satisfy the advance to the employee and any interest charges on that advance. The employee will receive the net number of the shares after the sale of a sufficient number of shares to satisfy the broker's advance. The sale of the shares to satisfy the broker's advance, however, is a disqualifying disposition of the ISO shares sold, and the employee must recognize ordinary income on the bargain purchase element of those ISO shares.

Example: B, an employee of X Corp., has an ISO to purchase 100 shares of X Corp. stock at $25 per share ($2,500 total exercise price). The ISO plan of X Corp. allows for exercise pursuant to a same-day sale program. Accordingly, when the market price of X Corp. stock is $50 per share and the ISO is fully exercisable, B notifies C, who is B's

[249] Reg. §1.422-5(d)(3).

[250] *See* II.E.2., above.

[251] Reg. §1.422-5(c).

[252] Reg. §1.422-5(d)(2) provides "[a]n option that includes an alternative right is not an incentive stock option if the requirements of Section 1.422-2 are effectively avoided by the exercise of the alternative right … . If either of two options can be exercised, but not both, each such option is a disqualifying alternative right with respect to the other, even though one or both options would individually satisfy the requirements of Sections 1.422-2, 1.422-4, and this section." The second quoted sentence clearly indicates that tandem options that would otherwise be ISOs if they were not in tandem will in all cases disqualify each other from ISO status. Caution is advised in providing alternative rights that are not clearly blessed by the regulations.

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broker, and requests a same-day sale exercise. C then remits $2,500 to X Corp. as payment of the ISO exercise price. X Corp. transfers the ISO shares to C. Upon receipt of the ISO shares, C sells 50 shares to satisfy the advance of the exercise price. C also sells an additional share to satisfy interest charges on the broker's advance. B receives 49 shares. The sale of 51 shares by C is a disqualifying disposition, and B must recognize ordinary income of $1,275 representing the bargain purchase element of those shares.

Practice Insight: A same-day sale exercise program is not ideally suited to the exercise of ISOs, because the subsequent sale of a portion of the ISO stock to pay the broker's advance of the exercise price is a disqualifying disposition of those ISO shares.[253]

F. Death of the ISO Holder

1. Exercise by Estate or Heir

The right to exercise an ISO and receive the related favorable tax treatment need not be lost upon the death of the employee. The ISO plan may provide for exercise of the ISO by the estate of the employee or by anyone who has acquired the ISO due to a bequest or inheritance from the employee or otherwise by reason of the death of the employee.[254] The same rules apply to exercise of the ISO by the estate or the heir as would have applied to the deceased employee, with two exceptions.[255] First, the estate or heir is not subject to the ISO holding period to which the employee would have been subject.[256] Therefore, the estate or heir will still receive favorable tax treatment even if a disposition of the shares occurs before the satisfaction of the holding period specified in §422(a)(1). The applicable capital gains holding periods, however, still apply for purposes of determining whether the gain or loss upon disposition of the stock will be subject to long-term or short-term capital gains treatment.[257]

Second, as long as the deceased employee met the employment requirements specified in §422(a)(2) at the time of death, the employment requirements for ISOs are satisfied and do not need to be separately met by the estate or heir. Accordingly, there is no requirement that the deceased employee's estate or heir exercise the ISO within three months following the employee's termination of employment so long as the employee's death occurred within three months following such termination of employment (within one year in the case of disability as described in Reg. §1.422-1(a)(3)).[258]

2. Disposition of ISO Stock

The ISO holding period does not apply to sale of the ISO stock by the estate or heir, but the capital gains holding periods apply.[259] The ISO holding period also does not apply to stock obtained directly from a deceased employee who had exercised the ISO while alive but died before the expiration of the applicable ISO holding period.[260]

Practice Insight: Practitioners should consult an estate and gift tax attorney when dealing with the death (or pending death) of the holder of an ISO. At a minimum, the following issues should be addressed:

- Will the exercise of the ISO be subject to the AMT provisions in §56(b)(3)?
- How is the value of the ISO determined for the purposes of Reg. §1.421-2(c)(4)?[261]
- What is the application of the automatic more than one-year holding period provision of §1223(9)?

G. Modification, Extension, or Renewal of ISOs

In general, the modification, extension, or renewal of an ISO will be considered the grant of a new option.[262] To qualify as an ISO, this new option must have an exercise price that is no lower than the fair market value of the stock subject to the option at the time of the modification, extension, or renewal, and it must meet all additional requirements that apply to ISOs generally.[263] If an ISO is amended such that, as amended, it fails to meet all of the requirements for ISO treatment, it will be treated as an NSO following such amendment.[264] This could occur, for example, if an ISO is amended to extend its exercise period to a period in excess of 10 years from the date of the amendment.[265] Conversely, the amendment of an NSO such that the option, as amended, satisfies the ISO requirements can transform an NSO into an ISO.[266] An option that otherwise satisfies the ISO requirements, however, will not be treated as an ISO if its terms expressly provide that it is not to be treated as an ISO.[267]

1. What Is a Modification of an ISO?

A modification of an ISO is any change in the terms of the option (or change in the terms of the plan pursuant to which the option was granted or in the terms of any other agreement governing the arrangement) that gives the optionee additional benefits under the option regardless of whether the optionee in fact benefits from the change in terms.[268] Thus, a change providing an extension of the period during which an option

[253] *See* Reg. §1.422-5(b)(2).

[254] §421(c)(1); Reg. §1.421-2(c)(1). *See also* Reg. §1.421-2(c)(4)(ii) (regarding the possible application of the rules of §691 and §1014(c) in the context of income in respect of a decedent if the exercise is not by the estate or by the person who acquired such option by bequest or inheritance or by reason of the death of such individual).

[255] §421(c)(1); Reg. §1.421-2(c)(1).

[256] §421(c)(1)(A).

[257] Reg. §1.421-2(c)(1).

[258] §421(c)(1)(A); Reg. §1.421-2(c)(1).

[259] Reg. §1.421-2(c)(1).

[260] Reg. §1.421-2(d).

[261] *See also* Rev. Proc. 98-34 (method for valuing certain compensatory stock options for estate tax and other purposes).

[262] §424(h)(1); Reg. §1.424-1(e)(2).

[263] §424(h)(1). *See generally* §422.

[264] Reg. §1.424-1(e)(5). A further consequence may be the application of §409A, which regulates deferred compensation arrangements, to the NSO.

[265] Such a modification would cause the option to fail to satisfy §422(b)(3).

[266] Reg. §1.424-1(e)(5).

[267] §422(b).

[268] §424(h)(3); Reg. §1.424-1(e)(4)(i).

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may be exercised (such as after termination of employment) or a change providing an alternative to the exercise of the option (such as a stock appreciation right) is a modification, regardless of whether the optionee in fact benefits from such extension or alternative right.[269] Similarly, a change providing an additional benefit upon exercise of the option (such as the payment of a cash bonus) or a change providing more favorable terms for payment for the stock purchased under the option (such as the right to tender previously acquired stock) is a modification.[270]

A change to an option that provides, either by its terms or in substance, that the optionee may receive an additional benefit under the option at the future discretion of the grantor is a modification at the time that the option is changed to provide such discretion.[271] In addition, the exercise of discretion to provide an additional benefit is a modification of the option.[272] It is not a modification, however, for the grantor to exercise discretion specifically reserved under an option with respect to the payment of a cash bonus at the time of exercise, the availability of a loan at exercise, or the right to tender previously acquired stock for the stock purchasable under the option.[273]

An offer to change the term of an ISO that remains open for less than 30 days is not a modification if the change is not made. Such an offer is a modification from the date of the offer if it remains open for 30 days or more, even if the change is not made.[274]

Modifications to ISOs usually add terms to the ISO that could have been included at the time of grant.[275] Therefore, it is important that the plan and grant document under which ISOs are granted contain all of the desired favorable provisions before the ISO is granted.

Certain changes to ISOs are not modifications.[276] For example, if an ISO is not immediately exercisable or vested on the date on which it is granted, any acceleration of exercisability or vesting of the ISO does not constitute a modification.[277] Changes in the administrative mechanics of ISO exercise, such as a change in the method to designate beneficiaries, also would not be considered a modification of an ISO.[278]

If an option is amended solely to increase the number of shares subject to the option, the increase is not considered a modification of the option but is treated as the grant of a new option for the additional shares. If, however, the exercise price and number of shares subject to an option are proportionally adjusted to reflect a stock split (including a reverse stock split) or stock dividend,[279] and the only effect of the stock split or stock dividend is to increase (or decrease) on a pro rata basis the number of shares owned by each shareholder of the class of stock subject to the option, then the option is not modified if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the option is not less than the aggregate exercise price before the stock split or stock dividend.[280]

Any inadvertent change to the terms of an option is not treated as a modification to the extent the modification is reversed by the earlier of the date the option is exercised or the last day of the calendar year during which such change occurred.[281]

If an ISO is modified, extended, or renewed in a manner that causes it to be treated under Reg. §1.424-1(e)(1) as a grant of a new NSO (i.e., a grant of a new option that doesn't qualify as an ISO), it must be treated, for purposes of §409A, as if it had been an NSO from the date of the original grant.[282] The option, however, may still remain exempt from §409A due to the requirement that the original exercise price was required to be at least equal to the fair market value of the underlying stock on the original grant date.[283]

2. *What Is an Extension or Renewal of an ISO?*

An extension of an ISO is the grant of additional time to exercise the option.[284] Of course, any extension of the time dur-

[269] Reg. §1.424-1(e)(4)(i). In contrast, for example, a change in the terms of the option shortening the period during which the option is exercisable is not a modification.

[270] Reg. §1.424-1(e)(4)(i).

[271] Reg. §1.424-1(e)(4)(iii).

[272] Reg. §1.424-1(e)(4)(iii).

[273] Reg. §1.424-1(e)(4)(iii).

[274] Reg. §1.424-1(e)(4)(iii).

[275] For example, if, at the time of grant, an ISO provides that the optionee's employer may, in its discretion, finance the exercise price of the ISO, then the exercise of that discretion and the resulting financing of the ISO exercise price will not constitute a modification of the ISO. Rev. Rul. 71-40. *See, e.g.*, PLR 8417034. Conversely, if, at the time of grant, the ISO does not provide that the granting corporation may finance the exercise price, then an agreement between the optionee and the corporation that the corporation will finance the exercise price of the ISO will constitute a modification of the ISO. *See, e.g.*, PLR 8501072, PLR 8352065. A modification of an ISO will not occur, however, if the granting corporation extends a loan to an optionee in order to refinance the optionee's third-party borrowings of the ISO exercise price so long as no agreement or understanding, either oral or written, was reached between the corporation and the optionee before ISO exercise. PLR 8501072, PLR 8352065. Moreover, the mere possibility that the granting corporation may extend a loan to an optionee to finance the exercise price of an ISO will not alone constitute a modification of the ISO. PLR 8501072, PLR 8352065.

[276] *See, e.g.*, PLR 9809025 (amendment of ISO plans to permit payment of option price by constructive delivery of previously acquired employer stock or through actual or constructive delivery of employer stock registered in optionee's name as trustee of revocable trust is not modification of options under §424(h) where ISO plans originally provided for payment of exercise price with actual delivery of previously acquired employer stock and constructive delivery will be treated in the same manner as payment by actual delivery). PLR 9809025 appears to rely on a distinction between the granting of a new right and the modification of the mechanism by which an existing right may be exercised.

[277] §424(h)(3)(C); Reg. §1.424-1(e)(4)(ii). In the case of an ISO that is exercisable before stock vesting (often referred to as "early exercisable"), there is some concern that acceleration of vesting of the underlying stock could be a modification. Because such acceleration is not explicitly excluded from the definition of "modification," care should be taken in amending an "early exercisable" ISO in this manner, and removal of the "early exercise" feature before amendment should be considered.

[278] *See* Rev. Rul. 69-648.

[279] Note that an adjustment to reflect a nonrecurring cash dividend may also not constitute a modification. *See* PLR 200728035.

[280] Reg. §1.424-1(e)(4)(v).

[281] Reg. §1.424-1(e)(4)(viii).

[282] Reg. §1.409A-1(b)(5)(ii).

[283] The granting of certain NSOs for service recipient stock meeting the requirements of Reg. §1.409A-1(b)(5)(i), including that the exercise price be at least equal to the fair market value of the stock at the date of the grant, is not considered a "deferral of compensation" under §409A. Thus, an option granted with an exercise price at least equal to the fair market value of the underlying stock on the date the option is granted will generally be exempt from §409A whether the option is an ISO or NSO. For a discussion of §409A, see 385 T.M., *Deferred Compensation Arrangements.*

[284] Reg. §1.424-1(e)(4)(vii). In the context of an acquisition transaction, however, the assumption of an ISO by an acquiring corporation will not constitute a modification or extension even if the original ISO, by its terms, would

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ing which the option may be exercised in excess of 10 years from the date on which the ISO was extended would cause the option to lose its qualification as an ISO.[285] A renewal is the grant of the same rights or privileges contained in the original option in a successive option. To qualify as an ISO, the terms of the new ISO, as renewed, would have to meet the general requirements applicable to all ISOs.

3. Option Repricing

The repricing of an ISO (i.e., the reduction of its exercise price without regard to a corporate reorganization, merger, or liquidation involving the assumption or substitution of the ISO) constitutes a modification of the ISO.[286] Accordingly, ISOs that are repriced are treated as new options granted on the date on which they are repriced and will qualify for ISO treatment only if they meet the general requirements applicable to all ISOs as of that date.

Corporations that offer optionees the opportunity to have their outstanding ISOs repriced should make certain that they do not simultaneously offer such holders alternative rights in both the original option and the repriced option. The regulations provide a useful rule permitting an employer to make an offer to modify an ISO's exercise price to current fair market value with up to a 30-day acceptance period, after which the offer will expire. This rule thus allows a repricing program to offer an ISO with a reduced exercise price in exchange for a higher-priced ISO and avoids the alternative right prohibition that otherwise could disqualify the ISOs of those who do not accept the offer of modification.[287]

4. Mergers and Acquisitions

The substitution of a new ISO for a prior ISO or the assumption of a prior ISO by an "eligible corporation" is not a modification if the substitution or assumption is by reason of a "corporate transaction," and certain other conditions are satisfied.[288] For this purpose: an "eligible corporation" includes a corporation that is the employer of an optionee or a parent or subsidiary of the employer corporation; and a "corporate transaction" includes (i) a corporate merger, consolidation, acquisition of property or stock, separation, reorganization, or liquidation involving such corporation, (ii) a distribution (excluding an ordinary dividend or a stock split or stock dividend) or change in the terms or number of outstanding shares of the corporation,[289] or (iii) such other corporate events as may be prescribed by the IRS in published guidance.[290] The determination of whether a corporation or a parent or subsidiary is the employer of the optionee is based upon the circumstances existing immediately after the corporate transaction.[291]

In the context of an ISO, the following conditions, among others, must be satisfied in order for a substitution or assumption in connection with a corporate transaction to not be considered a modification of the original ISO:

- *Spread Test:* The excess of the aggregate fair market value of the outstanding ISO shares over the aggregate ISO exercise price (the "aggregate bargain purchase element") after the substitution or assumption must not exceed the aggregate bargain purchase element before the substitution or assumption.

- *Ratio Test:* The ratio of the option exercise price to fair market value of the stock subject to the option after the substitution or assumption must not be more favorable to the optionee than the ratio before the substitution or assumption.[292]

Example: Immediately before Target is merged into Acquiring, Employee holds options to buy 60 shares of Target stock, then worth $32 per share, for an exercise price of $12 per share. Thus, the aggregate "bargain purchase element" of the options at this point is $1,200 (i.e., 60 × [$32 − $12]), and the ratio of exercise price to value is $12/$32, or 3/8. Substitution of 80 new Acquiring options, with an exercise price and value of $9 and $24, respectively, per share will satisfy the economic comparability criteria of Reg. §1.424-1(a)(5)(ii) and §1.424-1(a)(5)(iii) and will not constitute a "modification," because the aggregate bargain purchase element is still $1,200 (i.e., 80 × [$24 − $9]), and the ratio of exercise price to value, i.e., $9/$24, still equals 3/8.[293]

Generally, a change in an option or issuance of a new option is considered to be "by reason of" a corporate transaction unless the relevant facts and circumstances demonstrate that such change or issuance is made for reasons unrelated to the corporate transaction.[294] Such facts and circumstances might include, for example, an unreasonable delay between the corporate transaction and the change in the option or issuance of a new option, or if the corporate transaction serves no substantial corporate business purpose independent of the change in options. Similarly, a change in the number or price of shares purchasable under an option merely to reflect market fluctuations

otherwise have terminated. Reg. §1.424-1(a)(6). But, it may be important that the target corporation's ISO plan and ISO grants under that plan not be amended to delete the termination provision. See discussion below.

[285] *See* §422(b)(3).

[286] *See* Reg. §1.424-1(e)(4)(iv).

[287] Under Reg. §1.422-5(d)(2), an option that includes an alternative right is not an ISO if the requirements of Reg. §1.422-2 are effectively avoided by the exercise of the alternative right. For example, setting an option price below fair market value prevents an option from qualifying as an ISO. Accordingly, if an ISO holder is given the unrestricted right to elect a lower option price for an existing ISO, the ISO holder may have alternative rights (i.e., two exercise prices, one of which is below fair market value on the date the ISO was granted) in the ISO. By using a less-than 30-day acceptance period, those optionees who do not accept the repricing offer will not be considered to have had their options modified to provide an alternative right. However, care should be taken in satisfying both this 30-day limitation and any applicable period (e.g., 20 business days) during which an issuer tender offer must remain open under applicable securities laws. *See* Reg. §1.424-1(e)(4)(iii); Rule 14e-1 promulgated under the Exchange Act.

[288] The full set of requirements permitting certain changes to ISOs in connection with a "corporate transaction" is set forth in Reg. §1.424-1(a)(1) through §1.424-1(a)(10).

[289] *See, e.g.*, PLR 200925029 (special dividend distribution resulting from liquidation of subsidiary was a "corporate transaction" within the meaning of Reg. §1.424-1(a)(3)).

[290] Reg. §1.424-1(a)(3).

[291] Reg. §1.424-1(a)(2).

[292] §424(a)(1); Reg. §1.424-1(a)(5)(ii), §1.424-1(a)(5)(iii).

[293] *See* Reg. §1.424-1(a)(10) *Ex.* 6.

[294] Reg. §1.424-1(a)(4)(ii).

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in the price of the stock purchasable under an option is not by reason of a corporate transaction.[295]

In the context of an acquisition transaction, the assumption of an ISO by an acquiring corporation will not constitute a modification or extension even if the original ISO, by its terms, would otherwise have terminated upon the occurrence of certain corporate transactions.[296] It is important, however, that the target corporation's ISO plan and ISO grants under that plan not be amended to add a provision that provides assurances that the option will be assumed or substituted upon the occurrence of a corporate transaction.[297]

A change in an option or issuance of a new option is by reason of a distribution or change in the terms or number of the outstanding shares of a corporation only if the option as changed or the new option issued is an option on the same stock as under the old option (or if such class of stock is eliminated in the change in capital structure, on other stock of the same corporation).[298]

Practice Insight: The substitution or assumption of an ISO would not give the optionee additional benefits as long as the terms of the ISO (other than the change in the underlying stock) remain in effect with appropriate adjustments to the number of shares to which the option applies and to the per share exercise price. If the parties wish to use a standard form of agreement for the new corporation's ISO plan, it is important to ensure that the new standard form does not contain a feature (for example, a longer post-termination exercise period) that creates an additional benefit for the optionee. If it does, the new option would be treated as a new grant and would have to be retested to determine whether it would retain ISO status.

Practice Insight: The definition of a "corporate transaction" includes a distribution (including a distribution of cash) but excludes an ordinary dividend, a stock split, or stock dividend described in Reg. §1.424-1(e)(4)(v).[299] Because a distribution does not include a stock dividend or stock split (including a reverse stock split) that merely changes the number of outstanding shares of a corporation, an outstanding ISO is not treated as substituted or assumed in connection with such a change if it is proportionally adjusted to reflect the stock split or stock dividend and the aggregate exercise price of the option is not less than the aggregate exercise price before the stock split or stock dividend. This adjustment is not a modification of the option, and because the stock dividend or stock split is not a corporate transaction, the requirements of Reg. §1.424-1(a) do not have to be satisfied.

Preparation for a merger or acquisition involving a target corporation that has granted ISOs requires planning by the acquiring and target corporations. In the context of a merger or other acquisition, it is possible to have the acquiring corporation assume outstanding ISOs issued by the target corporation if the spread and ratio tests are met.

In determining the treatment of outstanding ISOs following a merger transaction, care should be taken by the issuing employer that the treatment of the ISOs does not result in an inadvertent modification of the ISOs, thus requiring an increase in the exercise price to maintain ISO status and a possible accounting charge.[300] For example, if an ISO plan specifically bars a change in outstanding ISOs upon a merger or similar transaction, the removal of that bar will constitute a modification of the ISO,[301] although this would not prevent the acquiring corporation from assuming or substituting options that would retain ISO status.[302] Conversely, in order to facilitate such an assumption, an ISO plan can be drafted to provide that upon a merger or other acquisition transaction, ISOs outstanding under the plan may be assumed by, or replaced with comparable stock options issued by, the acquiring corporation.[303]

Practice Insight: As noted above, there can be significant differences in tax treatment if an ISO is exercised before the closing of a merger or other acquisition. For example, if an ISO is exercised before a cash merger, the disqualifying disposition

[295] Reg. §1.424-1(a)(4)(ii).

[296] Reg. §1.424-1(a)(6).

[297] *Compare* Rev. Rul. 71-217 ("The deletion of the termination provision of the options in question and the substitution therefor of a clause which provides assurances that the option will be replaced by a new option of comparable value or assumed by a successor corporation notwithstanding the occurrence of the designated corporate transactions confers upon the employee a benefit he did not have previously. Accordingly, this amendment is a modification … .") *with* Rev. Rul. 58-499 (ruling that an "assumption or substitution" in a corporate transaction may still fall under the Code exception, providing that such an "assumption or substitution" is not a disqualifying "modification," notwithstanding that the terms of the old option provide for its termination on the occurrence of certain corporate transactions, as long as requirements for parity of economic terms between old and new options were satisfied). Rev. Rul. 71-217 distinguished Rev. Rul. 58-499 on the grounds that Rev. Rul. 58-499 did not involve the addition to an option of a provision that provided assurances that the option would be assumed or substituted upon the occurrence of a corporate transaction. *See also* PLR 8641048 ("The 'interpretation' by the Committee dated July 22, 1985, constitutes a modification of outstanding options … because it provides optionees with the assurance that upon retirement at age 65 an option will not become unexercisable because an optionee's accumulated payroll deductions may be insufficient to purchase the number of shares of X stock the optionee elected to purchase at the beginning of a purchase period.").

[298] Reg. §1.424-1(a)(4)(iii).

[299] Reg. §1.424-1(a)(3)(ii). *See also* Reg. §1.424-1(a)(10) *Ex.* 2(iii). For example, in PLR 200728035, the IRS held that a special nonrecurring cash dividend qualified as a corporate transaction within the meaning of Reg. §1.424-1(a)(3).

[300] *See* II.G.1., above, and II.J., below.

[301] *See* Rev. Rul. 71-166 ("Under the provisions of the plan no adjustments in the number and price of shares subject to outstanding options could be made to reflect stock dividends, unless the stock dividends in the course of a calendar year increased the corporation's number of outstanding shares by more than four percent, in which case the excess over four percent would be reflected in an adjustment … . Accordingly, in the instant case the change made by the corporation in its qualified stock option plan that removed the four percent limitation and permitted adjustments to outstanding qualified stock options to reflect the full seven percent stock dividend was a modification of the outstanding options within the meaning of section 425(h)(3) of the Code."). *But see* PLR 200007033, in which the company declared a large special dividend and simultaneously effected a reverse stock split of its shares. The size of the reverse stock split was designed so that its effect on the price of the company's shares would almost exactly offset the dividend's effect on that price. Despite the anti-dilution provisions in the company's plan, the company did not make any adjustments to the options to reflect the reverse stock split "based [on the conclusion] … that the overriding purpose of the anti-dilution provisions was to keep the optionees whole, and that adjustments to the options to reflect the reverse stock split, if not accompanied by adjustments to reflect the special dividend, would be contrary to that purpose." The PLR concluded that the failure to adjust the options based on the reverse stock split was not a modification since it was effectuating the original intent of the anti-dilution provisions. The PLR distinguished Rev. Rul. 71-166 on the grounds that, unlike in the Rev. Rul. 71-166, "this is not a situation where the plan provisions in question were specifically designed to adversely affect the employees."

[302] Reg. §1.424-1(a)(6).

[303] See the sample stock option plan in the Worksheets for an example of such provisions.

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rules apply, and there will be no income or employment tax withholding applied; whereas, if the ISO is not exercised but instead the option holder receives a cash payment for the ISO, such payment will be ordinary income subject to income and employment tax withholding. There is a perplexing question in cash mergers where options are not being assumed (and will be cashed out on the same basis as if exercised on a basis that is net of the exercise price) whether a purported exercise of an ISO that is contingent on the merger closing should be respected as an exercise immediately followed by a disqualifying disposition or as if the option were cashed out. (In such a "contingent at closing exercise" the optionee never has the "benefits and burdens" of a stockholder of the target corporation's stock because immediately following the exercise the merger occurs converting the optionee's target corporation stock into the merger consideration.) A conservative practitioner representing the acquiring corporation may insist on treating contingent at closing exercises of ISOs as if the ISOs were being cashed out so that the required withholding will be collected if the IRS should subsequently determine that withholding was required. Similarly, a conservative practitioner representing a holder of an ISO who wants to achieve disqualifying disposition treatment might suggest the following exercise scenario. By the close of business on the second business day preceding the closing, the option holder irrevocably exercises the ISO by tendering the exercise price and any required paperwork to the target corporation. If the exercise price is paid with the option holder's check, the target corporation would presumably deposit such check in its bank the next day (i.e., the day before the closing). Thus, the ISO will have been exercised and the optionee converted into a holder of target corporation stock even if the merger falls apart at the last minute.

On June 22, 2016, the IRS issued proposed regulations on certain aspects of §409A.[304] Included in the proposed regulations is a provision clarifying that the special payment rules for "transaction-based compensation" payments apply to a statutory stock option.[305] Transaction-based compensation payments are payments related to certain types of changes in control that (1) occur because a service recipient purchases its stock held by a service provider or because the service recipient or a third party purchases a stock right held by a service provider or (2) are calculated by reference to the value of service recipient stock.

Under the current §409A regulations, transaction-based compensation may be treated as paid at a designated date or pursuant to a payment schedule that complies with §409A(a) if it is paid on the same schedule and under the same terms and conditions as apply to payments to shareholders generally with respect to stock of the service recipient pursuant to the change in control. Likewise, transaction-based compensation meeting these requirements will not fail to meet the requirements of the initial or subsequent deferral election rules under §409A if it is paid not later than five years after the change in control event.

The proposed regulations clarify that the special payment rules for transaction-based compensation apply to a statutory stock option or a stock right that did not otherwise provide for deferred compensation before the purchase or agreement to purchase the stock right. Accordingly, the purchase (or agreement to purchase) such a statutory stock option or stock right in a manner consistent with the proposed regulations would not result in the statutory stock option or stock right being treated as having provided for the deferral of compensation from the original grant date.

H. Comparison of ISOs and NSOs

An employer has the choice of two types of stock options that can be used to compensate employees — ISOs and NSOs. An ISO plan may provide for the granting of NSOs.[306]

1. Structure of Option Arrangement

The reason an employer would grant ISOs instead of NSOs would be to enable its employees to defer the taxability of option gain from the date of exercise to the date of a subsequent taxable sale or disposition of the underlying stock and to obtain favorable capital gains treatment on the spread.

By contrast, the major disadvantage of NSOs from an employee's perspective is that the employee will be required to recognize ordinary income upon option exercise.[307] The employer, however, will be permitted to take an offsetting compensation deduction in the taxable year with or within which the employee recognizes ordinary income.

An employer has more flexibility in designing an NSO program than an ISO program because it is not restricted by the detailed qualification rules applicable to ISOs. The application of §409A to NSOs with a discounted exercise price (i.e., an exercise price that is less than the fair market value of the stock on the date the NSO is granted), however, has effectively extended the requirement of §422(b)(4) to most NSOs. Furthermore, the general requirement for publicly traded corporations that NSOs be issued pursuant to shareholder-approved plans has effectively extended the requirement of §422(b)(1) to most NSOs. Accordingly, the added flexibility of NSOs over ISOs has been significantly reduced. There are, however, some circumstances where the added flexibility of NSOs continues to be important. For example, NSOs may be granted to individuals who are not employees, such as valued independent contractors. Also, unlike ISOs, NSOs can be granted pursuant to a plan that is effective for more than 10 years, and the options can be outstanding for more than 10 years from date of grant. Furthermore, NSOs may be fully transferable. Finally, there need not be any restric-

[304] REG-123854-12, 81 Fed. Reg. 40,569 (June 22, 2016). The provisions of the proposed regulations that amend the existing final regulations are proposed to be applicable on or after the date on which they are published as final regulations. For periods before the publication date of new final regulations, the existing final regulations and other applicable guidance apply without regard to the proposed regulations. Taxpayers may rely on the proposed regulations before they are published as final regulations, however, and until new final regulations are published the IRS will not assert positions that are contrary to the positions set forth in the proposed regulations. Preamble to REG-123854-12, 81 Fed. Reg. 40,569, 40,577.

[305] *See* Prop. Reg. §1.409A-3(i)(5)(iv)(A); preamble to REG-123854-12, 81 Fed. Reg. 40,569, 40,582.

[306] For a discussion of NSOs, see 383 T.M., *Nonstatutory Stock Options.* Although NSOs may be issued pursuant to an ISO plan, tandem ISO/NSOs (or tandem ISO/ISOs) will result in both options being treated as NSOs. *See* Reg. §1.422-5(d)(2). A tandem ISO/NSO occurs when both options are granted together and the exercise of one affects the right to exercise the other.

[307] Generally, the taxable event for an NSO is the option exercise, because of the requirement under §83 that, to be taxable at grant, an NSO must have a readily ascertainable fair market value at the date of grant. Reg. §1.83-7(a).

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tions on the value of options that can first become exercisable in a single year or on the timing of disposition of the option stock after exercise.[308]

2. Taxation of Option Arrangement

The taxation of NSOs is governed by §83. The following discussion is a simplified comparison of the tax treatment of an ISO with that of an NSO and is not a complete discussion of either tax treatment.

a. Grant of Option

In general, neither the value of an ISO nor the value of an NSO is included in the option recipient's income at the time of grant unless, in the case of an NSO, the option stock has a readily ascertainable fair market value on the date of grant.[309] Only options that are traded on an established market or that have a fair market value that can be measured with reasonable accuracy and that meet certain other conditions, have a readily ascertainable fair market value.[310]

b. Exercise of Option

The major difference between the tax treatment of ISOs and that of NSOs relates to the tax treatment at the time of exercise. In general, the difference between the exercise price of an NSO and the fair market value of the stock received upon exercise will be recognized as ordinary income.[311] In contrast, the optionee is not required to recognize taxable income upon the exercise of an ISO. The exercise of an ISO, however, will result in an item of adjustment for alternative minimum tax (AMT) purposes, but there are no AMT consequences triggered by the exercise of an NSO apart from the recognition of ordinary income.

As noted above, a §83(b) election is ineffective upon an exercise of an ISO as to unvested shares followed by a disqualifying disposition of such shares. If, therefore, an optionee intends to exercise his option before the shares are vested and wants to file a §83(b) election (presumably because the optionee believes there could be little or no income to recognize), an NSO may provide a superior tax result by minimizing the potential amount of ordinary income and short-term capital gain and maximizing the minimizing amount of long-term capital gain.

c. Sale of Option Stock

When stock received through the exercise of the option is sold, all the gain on the sale of either ISO stock (as long as the sale was not a disqualifying disposition) or NSO stock will be subject to capital gains treatment. Because the basis of the ISO stock is only the original exercise price (due to the nonrecognition of gain on exercise) and the basis of the NSO stock is the fair market value of the NSO stock at exercise, the amount that is taxed as capital gains will differ.

d. Capital Gains Tax Rate

ISOs also provide more favorable tax results than NSOs for taxable years in which long-term capital gains are taxed at a lower rate than ordinary income, because gain upon the disposition of ISO stock after the ISO holding period expires is taxed at long-term capital gains rates. Thus, the bargain purchase element of an ISO will be subject to the maximum tax rate applicable to long-term capital gains at the later disposition if the

[308] As explained above in II.D., §13601 of the Tax Cuts and Jobs Act (TCJA), amended §162(m) to remove the exception for performance-based compensation. The amendments made by §13601 are generally effective for taxable years of the employer beginning after December 31, 2017. Compensation provided pursuant to a written binding contract, however, which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date, receives legacy status and remains subject to the prior version of §162(m), including the performance-based compensation exception. In its 2019 Proposed Regulations and 2020 Final Regulations, the IRS provided guidance on the amendments to §162(m) in the TCJA, including guidance on the definition of "written binding contract" and "material modification" for purposes of the legacy treatment. *See* Reg. §1.162-33, added by T.D. 9932, 85 Fed. Reg. 86,481 (Dec. 30, 2020), generally effective on or after December 30, 2020, with the option for earlier applicability with respect to taxable years beginning after December 31, 2017. Soon after the enactment of the TCJA, the IRS provided interim guidance on §162(m). See Notice 2018-68. However, the preamble to the 2019 Proposed Regulations states that, except as provided by the special applicability dates, taxpayers may no longer rely on the interim guidance of Notice 2018-68 for taxable years ending on or after December 20, 2019. 84 Fed. Reg. at 70,370. For corporations seeking to preserve compensation deductibility for grandfathered amounts in the face of the $1 million limit under §162(m) by applying the performance-based compensation exception, both NSO and ISO plans must specify the number of shares that can be awarded to an individual employee during a prescribed period. A plan satisfies this per-employee limitation requirement if it specifies an aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, restricted stock units and other equity-based awards may be granted to any individual employee during a specified period under a plan approved by shareholders in accordance with the final regulations. *See* Reg. §1.162-27(e)(2)(vi)(A) and §1.162-27(e)(2)(vii) *Ex.* 9, amended by T.D. 9716, 80 Fed. Reg. 16,970 (Mar. 31, 2015), effective for grants on or after June 24, 2011. In addition, if the amount of compensation the employee could receive under a grant or award is not based solely on an increase in the value of the stock after the date of grant or award (for example, in the case of restricted stock, or an option with an exercise price less than the fair market value of the stock on the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation. Reg. §1.162-27(e)(2)(vi)(A), amended by T.D. 9716. The practice of backdating or misdating stock options may jeopardize the option's status as performance-based compensation under §162(m) if there is a discrepancy between the fair market value of the stock on the actual date of grant and the fair market value on the purported date of grant. *See* AM 2009-006. For further discussion of §162(m), see 390 T.M., *Reasonable Compensation.* For taxable years ending on or after October 3, 2008, through October 3, 2010, the §162(m) deduction limit was generally reduced for certain taxable years for any financial institution that was an employer from which one or more troubled assets were acquired under the Troubled Assets Relief Program if the aggregate amount of the assets acquired for all taxable years exceeded $300 million. §162(m)(5), added by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Div. A, §302.

[309] Reg. §1.83-7(a), §1.83-7(b).

[310] Reg. §1.83-7(b). An option that is not actively traded on an established market will have a readily ascertainable fair market value if: (1) the option is transferable by the optionee; (2) the option is exercisable immediately in full by the optionee; (3) the option or the option stock is not subject to any restrictions that would affect the value of the stock; and (4) the fair market value of the option privilege is ascertainable. Reg. §1.83-7(b)(2). *See Cramer v. Commissioner*, 101 T.C. 225 (1993) (confirming the validity of Reg. §1.83-7(b)(2)), *aff'd*, 64 F.3d 1406 (9th Cir. 1995). *See also* the discussions in 383 T.M., *Nonstatutory Stock Options*, and 384 T.M., *Restricted Property — Section 83*. For the balance of this Portfolio, it will be assumed that an NSO does not have a readily ascertainable fair market value.

[311] Reg. §1.83-7(a); §83(a).

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option was an ISO.[312] By contrast, the bargain purchase element of an NSO is taxed as ordinary income upon exercise.

Example: On January 1, 2020, B, an employee of X Corp., is granted 100 ISOs to purchase shares of X Corp. stock at $10 per share. B is also granted 100 NSOs at $10 per share. On June 1, 2022, when the fair market value of X Corp. stock is $20 per share, B exercises all his ISOs and NSOs. On December 31, 2023, when the fair market value of X Corp. stock is $25 per share, B sells all the X Corp. stock previously acquired in the June 1, 2022, exercises. The tax consequences are as follows:

Date	ISO Consequences	NSO Consequences
January 1, 2020 (grant of options)	None	None
June 1, 2022 (exercise of options)	• No regular income consequences • $1,000 AMT preference adjustment • No employment tax consequences • Potential AMT tax credit carryover may be created	• $1,000 ordinary income for regular tax purposes • No AMT consequences (other than that generated by the regular income) • $1,000 subject to withholding of income and employment taxes
December 31, 2023 (sale of stock)	• $1,500 of long-term capital gains for regular tax purposes • $500 of long-term capital gains for AMT purposes • Potential 3.8% surcharge • No employment tax consequences	• $500 of long-term capital gains for regular tax purposes • No AMT consequences (other than that generated by the regular income) • Potential 3.8% surcharge • No employment tax consequences

e. Deduction for Employer

An employer is not entitled to a compensation deduction on account of an employee's exercise of an ISO unless there is a subsequent disqualifying disposition. By contrast, an employer is entitled to a compensation deduction for its taxable year with or within which the employee recognizes ordinary income with respect to an NSO.[313] The deduction will be equal to the difference between the fair market value of the NSO stock and the exercise price of the option.[314]

f. Overall Tax Effectiveness

Employers that want to provide an opportunity for employees to share in increases in the employer's share price have a variety of methods to do so, including ISO, NSOs, stock appreciation rights, and restricted stock units. Each of these methods has advantages and disadvantages for the employer and employees. Comparing ISOs and NSOs, ISOs have significant tax advantages to employees by allowing them to defer ordinary income tax until the stock is sold and, if the holding periods are satisfied, to obtain long-term capital gains treatment on the entire gain, including the spread at exercise. Issuing ISOs rather than NSOs may also allow the employee and employer to avoid employment taxes that could apply to NSOs.

These advantages are offset to some extent by the requirement to treat the ISO exercise as a preference item for AMT purposes and by the absence of a deduction for the employer if the employee does not have a disqualifying disposition.[315] Depending on factors such as the employee's AMT status and the employer's tax rate, it may be more advantageous, from a "holistic economic approach" that takes into account net costs and net benefits to the employer and the employee, for the employer to grant the employee an increased number of NSOs rather than a smaller number of ISOs.

Another consideration in deciding between ISOs and NSOs is the financial and tax sophistication of the group of employees that will be eligible for the options. ISOs are more complex than NSOs. If employees find it difficult to understand the advantages of ISOs, they may be less effective as an incentive for superior performance.

Although publicly traded corporations will often be able to choose between offering ISOs and NSOs (or a mix), ISOs will often be the option of choice for privately held corporations. The lack of liquidity associated with privately held stock often places an added premium on the ISO's ability to avoid ordinary income on exercise.

I. Securities Law and Stock Exchange Treatment of Stock Options

Although this Portfolio is primarily concerned with federal tax issues associated with stock options, a brief overview of securities law and stock exchange considerations affecting the

[312] §1(h). For tax years beginning after December 31, 2017, the maximum tax rate on long-term capital gains is 0%, 15%, or 20%, depending on the taxpayer's income and filing status. §1(j), as added by TCJA, Pub. L. No. 115-97, §11001(a) (temporary rate change through tax years beginning before January 1, 2026), and amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70101(a) (extending rate change), effective for tax years beginning after December 31, 2025. In addition, under §1411, a surcharge of 3.8% may apply to the lesser of (a) net investment income, or (b) the excess of modified adjusted gross income over the following threshold amounts: (i) $250,000 for married filing jointly or qualifying surviving spouse with dependent child, (ii) $125,000 for married filing separately, and (iii) $200,000 in all other cases. Net investment income generally includes gains from the sale of stock.

[313] The employee's year of income recognition generally will be the employee's taxable year of option exercise, unless the NSO has a readily ascertainable fair market value at the date of grant.

[314] §83(h).

[315] Even if the employee has a disqualifying disposition, the employer may still obtain a somewhat larger overall deduction from an NSO arrangement. In general, the NSO deduction will be the spread on exercise; whereas, in general, the ISO deduction from a disqualifying disposition will be the lesser of the spread on exercise or the gain realized on sale. Thus, if the employer's stock declines in value after the exercise, the NSO arrangement will produce a somewhat larger deduction than will an ISO arrangement with disqualifying dispositions. (Of course, the optionee suffers a detriment in the form of higher ordinary income and a capital loss that may not offset the effect of the higher ordinary income.)

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grant and exercise of options and the disposition of option stock may be useful. Practitioners should consult a securities law attorney.[316]

1. Federal Securities Laws

The Securities Act of 1933 (the "1933 Act") generally requires registration of sales of stock pursuant to stock options because of the optionee's investment decision whether to exercise the option and thus invest in the stock.[317] Registration, typically using Form S-8, *Registration Statement Under the Securities Act of 1933*, must be effective not later than the earliest date on which the option is exercisable.

For corporations, the securities of which are not publicly traded, Rule 701 is the typical exemption from registration that will be followed in granting options and issuing option stock to employees.[318] The rule applies to arrangements that are part of a written compensatory benefit plan or written compensatory contract and not involved with the raising of capital. The maximum value of securities that may be sold in a 12-month period pursuant to Rule 701 is the greatest of the following:

- $1 million;
- 15% of the issuer's total assets; or
- 15% of the outstanding securities of the class being offered.[319]

In the case of options, the underlying securities are deemed "sold," and therefore, this calculation must be made as of the date of option grant and using the option exercise price, without regard to whether the option is then exercisable or vested.[320] The employer must disclose the terms of the plan or contract.[321] Certain additional disclosures (certain financial statements, a statement of risk factors, and a summary of the material terms of the plan) are required under Rule 701 if securities exceeding $10 million in value are sold during a 12-month period.[322] Such disclosure must be made a reasonable period of time before the date of option exercise.[323]

Because an option is considered a derivative security under the Securities Exchange Act of 1934 (the "1934 Act"), its beneficial ownership must be reported under §16(a) of the 1934 Act by officers, directors, and 10% shareholders ("Insiders") of the issuing corporation.[324] Furthermore, §16(b) of the 1934 Act requires Insiders to disgorge to the issuer any profits derived from the purchase or sale of an equity or derivative security within a six-month period.[325] Rule 16b-3, however, provides that option grants will be exempt transactions, and thus not matchable with other securities transactions involving issuer stock, if one of the following conditions is satisfied:

- the option grant is approved by the corporation's entire board of directors or by a committee of the board of directors composed solely of two or more "non-employee directors;"
- the option grant is approved or ratified by the corporation's stockholders not later than the next annual meeting; or
- the optionee holds the securities for at least six months from the date received.[326]

The acquisition of a derivative security, such as an option, is regarded as an acquisition of the option stock. Thus, the exercise of an in-the-money option is generally not an acquisition for purposes of §16(b) of the 1934 Act.[327]

Under §12(g) of the 1934 Act, every issuer with more than $10 million of assets and a class of equity security held by either 2,000 or more shareholders or 500 or more shareholders who are not accredited investors (as defined by the SEC) at the end of its most recent fiscal year must register the class of equity security, unless there is an available exemption from registration.[328] ISOs and other options issued to employees are a separate class of equity securities for purposes of §12(g)[329] and grants to 500 or more optionees by an issuer with more than $10 million in assets trigger the registration requirement under §12(g), unless there is an available exemption. The SEC adopted an exemption for private, non-reporting issuers from the §12(g) registration requirements for compensatory employee stock options issued under written compensatory stock option plans if a number of conditions are met that are intended to preclude trading in compensatory stock options and, thus, to ensure that there are no public investors that need the full range of protection that registration would provide.[330]

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[316] For further discussion of securities law issues affecting employee benefit plans, see 362 T.M., *Securities Law Aspects of Employee Benefit Plans.*

[317] 15 U.S.C. §77a *et seq.*

[318] 17 C.F.R. §230.701. Other exemptions, such as a private placement pursuant to §4(2) of the 1933 Act or an offering pursuant to Regulation D (17 C.F.R. §230.500, *et seq.*, 77 Fed. Reg. 18,684 (Mar. 28, 2012)), are possible but considerably less flexible than Rule 701. Note that, effective April 5, 2012, Pub. L. No. 112-106, §201, effectively redesignated §4(2) of the 1933 Act as §4(a)(2) and modified provisions regarding the general advertising or solicitation of offers and sales as public offerings.

[319] 17 C.F.R. §230.701(d)(2).

[320] 17 C.F.R. §230.701(d)(3)(ii).

[321] 17 C.F.R. §230.701(e).

[322] 17 C.F.R. §230.701(e). Originally, the dollar limitation was $5 million. The SEC increased the limit pursuant to requirements set forth in the Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, §507. SEC Release No. 33-10520, 83 Fed. Reg. 34,940 (July 24, 2018).

[323] 17 C.F.R. §230.701(e).

[324] 17 C.F.R. §240.16a-1(c), §240.16a-4.

[325] 15 U.S.C. §78p(b).

[326] 17 C.F.R. §240.16b-3(d).

[327] 17 C.F.R. §240.16b-6(b).

[328] 1934 Act, §12(g)(1), 15 U.S.C. §78l(g)(1), as *amended by* Pub. L. No. 112-106, §501, effective April 5, 2012; 17 C.F.R. §240.12g-1, as *amended by* 81 Fed. Reg. 28,689 (May 10, 2016), effective June 9, 2016 (a special rule applies to a bank, savings and loan holding company or bank holding company). Previously, issuers were required to register a class of equity security if they had 500 or more holders of record of that class of equity security and assets over a threshold amount at the end of the most recent fiscal year, unless there was an available exemption from registration.

[329] 15 U.S.C. §78c(a)(11) (defining equity security to include any right to purchase a security (such as an option)); 17 C.F.R. §240.3a11-1 (explicitly including options in the definition of equity security for purposes of §12(g)); 15 U.S.C. §78l(g)(5) (defining class to include "all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges.").

[330] 17 C.F.R. §240.12h-1(f). As a condition to the exemption, issuers must include the necessary limitations and conditions in the written compensatory stock option plans, within the terms of the individual written stock option agreements or in certain other types of enforceable written agreements. Before December 2007, the SEC granted no action relief to permit private corporations to grant options to 500 or more optionholders, but the terms of such exempted arrangements were somewhat restrictive. *See, e.g.*, No Action Letters to VC Holding Corporation (Oct. 31, 2006), Headstrong Corporation (Feb. 28, 2003),

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2. State Securities Laws

Securities that are exempt from federal registration, by reason of Rule 701 or another exemption, may still require registration under the securities laws of the various states. Rule 701 analogues exist in many states, thus relieving issuers that comply with Rule 701 from additional state registration,[331] although a simple notice still may need to be filed.

3. Stock Exchange Requirements

The requirements for listing a corporation's stock on a national securities exchange may include stockholder approval of the plan under which options are granted as well as stockholder approval of certain types of plan modifications.[332]

J. Accounting Treatment of Stock Options

This section provides a brief overview of the accounting requirements applicable to ISOs. For a more complete discussion of the accounting treatment of options, see 341 T.M., *Accounting for Share-Based Compensation.*

An employer must account for the use of ISOs, as with any other compensatory arrangement, as a compensation cost against income.[333] The compensation cost relating to stock options granted to employees is determined on the measurement date, which is the date on which there is a mutual understanding of the key terms and conditions of the option and the employer becomes contingently obligated to issue the shares.[334] For purposes of most ISO grants, the date of grant will be the measurement date. If, however, the grant is subject to shareholder approval, the date of grant will not occur until the requisite shareholder approval has been obtained, unless shareholder approval is essentially a formality.[335]

Generally effective for public business entities for fiscal years beginning after December 15, 2018, including interim period within that fiscal year, the compensation cost for nonemployees is measured at the grant date, defined as the date at which a grantor and grantee reach a mutual understanding of the key terms and conditions of a share-based payment award.[336]

The amount of the compensation cost resulting from the grant of an ISO is equal to the "fair value" of the option on the date of grant.[337] The fair value of an ISO is calculated using an option valuation model such as the Black-Scholes-Merton option pricing formula or other valuation models (for example, a lattice model).[338] Applying one of these models, the fair value of an ISO on the date of grant will be greater than zero. This compensation cost is reported directly on the employer's income statement.

On October 25, 2021, the Financial Accounting Standards Board released an Accounting Standards Update that provided a simplified method for determining the fair value of stock options issued by private companies.[339] The amendment allows a private company to determine the current price of the underlying stock using a valuation method that meets all of the requirements to be presumed to be reasonable, for purposes of §409A, for valuing stock that is not readily tradable on an established securities market.[340]

Once an ISO has been valued on the measurement date, no further compensation cost need be recognized on the employer's income statement unless a new measurement date occurs. With very limited exceptions,[341] a modification of an ISO is treated as an exchange of the original award for a new award, thus potentially resulting in the employer's recognition of an additional compensation cost.[342] If an equity award is modified after the grant date, incremental compensation cost will be recognized in an amount equal to the excess, if any, of the fair

AMIS Holdings, Inc. (July 30, 2001), Mitchell International Holding, Inc. (Dec. 27, 2000), General Roofing Services, Inc. (Apr. 13, 2000), Kinko's, Inc. (Nov. 30, 1999), Starbucks Corporation (Apr. 2, 1992). *See* the Worksheets for an example of a Rule 12h-1(f) provision.

[331] *See, e.g.*, Massachusetts, New Jersey, and Pennsylvania.

[332] *See, e.g.*, NYSE Listed Company Manual, §303A.08, *available at* https://nyseguide.srorules.com/listed-company-manual (shareholder approval policy of equity compensation plans); NASDAQ Marketplace Rule 5635, *available at* https://www.nasdaq.com/market-regulation.

[333] The term "compensation cost" is used instead of the term "compensation expense" to reflect the fact that certain eligible employee "costs" may be capitalized under the relevant GAAP. Note that, effective for interim and annual periods ending after September 15, 2009, the Financial Accounting Standards Board (FASB) codified all of its authoritative nongovernmental U.S. generally accepted accounting principles (U.S. GAAP) into a single source in its Accounting Standards Codification (FASB ASC), *available at* http://asc.fasb.org.

[334] *See* Statement of Financial Accounting Standards No. 123, revised in 2004 as FAS 123(R), ¶A77, codified at FASB ASC ¶718-10-55-4 and ¶718-10-55-81, effective for interim and annual periods ending after September 15, 2009. FASB ASC ¶718-10-55-4 and ¶718-10-55-81 were amended by FASB ASU No. 2018-07 to expand the scope of Topic 718, *Compensation — Stock Compensation*, to include share-based payment transactions for nonemployees, effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year.

[335] FAS 123(R), ¶A77, codified at FASB ASC ¶718-10-55-82, effective for interim and annual periods ending after September 15, 2009. This accounting rule should be distinguished from the ISO stockholder approval rules which provide that the date of grant is the date that the corporation took the action to grant the options (not the later date of stockholder approval) even when the ISOs are conditioned on receiving later stockholder approval. FASB ASC ¶718-10-55-82 was expanded by FASB ASU No. 2018-07 to provide for share-based payment transactions for nonemployees.

[336] FASB ASU No. 2018-07.

[337] FAS 123(R), ¶16, codified at FASB ASC ¶718-10-30, effective for interim and annual periods ending after September 15, 2009, and amended by FASB ASU No. 2018-07.

[338] FAS 123(R), ¶A13, codified at FASB ASC ¶718-10-55-16, effective for interim and annual periods ending after September 15, 2009, and amended by FASB ASU No. 2018-07.

[339] FASB Accounting Standards Update, *Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*, *available at*, https://fasb.org/Page/ShowPdf?path=ASU_2021-07.pdf (Oct. 25, 2021).

[340] *See* Reg. §1.409A-1(b)(5)(iv)(B)(2).

[341] For annual periods (including interim periods within those annual periods) beginning after December 15, 2017, an entity must disclose but does not have to account for modification if (1) the fair value (or calculated value or intrinsic value, if such alternative valuation is used) of the modified award, (2) the vesting conditions of the modified award, and (3) the classification of the modified award as an equity instrument or a liability instrument are all the same as that of the original award immediately before the original award is modified. FASB ASC ¶718-20-35-2A, ¶718-20-65-1.

[342] FAS 123(R), ¶51, codified at FASB ASC ¶718-20-35-3, effective for interim and annual periods ending after September 15, 2009. A modification is defined in Appendix E of FAS 123(R) and the Glossary of the FASB ASC as a "change in any of the terms or conditions of a share-based payment award." FASB ASC ¶718-20-35-3 was amended by FASB ASU No. 2017-09 to incorporate FASB ASC ¶718-20-35-2A.

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value of the modified award over the fair value of the original award immediately before the modification.[343]

If an unvested ISO is modified, any additional compensation cost will be recognized over the remaining vesting period.[344] If a vested ISO is modified, any additional compensation cost will be recognized immediately in full.

As discussed in II.G., above, certain modifications to ISOs may cause the option to cease to be treated as an ISO for tax purposes. In such cases, the options would be treated as NSOs. Although ISOs and NSOs are treated the same way for purposes of recording the compensation cost, the related income taxes are accounted for differently. Upon the grant of an NSO, the employer recognizes a deferred tax asset. With respect to ISO grants, however, it is only if the employee engages in a disqualifying disposition of an ISO that the employer would recognize a tax benefit.

K. International Issues

It is common for a U.S. corporation to employ individuals to perform services at locations outside of the United States. If these foreign employees are neither citizens nor residents of the United States ("non-U.S. employees") and perform services exclusively outside of the United States, generally, they will not be subject to U.S. federal income taxes.[345] Because ISOs are designed to provide favorable treatment under U.S. federal income tax law, non-U.S. employees who are not subject to taxation in the United States (unless they become subject to U.S. taxation at the time of ISO exercise) may derive no additional benefit from receiving an ISO rather than an NSO. Such non-U.S. employees likely will be taxed identically under their local laws without regard to the type of option they receive.[346]

[343] FAS 123(R), ¶51, codified at FASB ASC ¶718-20-35-3, effective for interim and annual periods ending after September 15, 2009.

[344] FAS 123(R), ¶A152, Illustration 12(c), codified at FASB ASC ¶718-20-55-98, effective for interim and annual periods ending after September 15, 2009.

[345] §862(a)(3), §872(a).

[346] Nonetheless, in certain situations, it may be possible to create a "sub-plan" that adopts an employer's general U.S. equity incentive plan provisions and also incorporates rules that will enable non-U.S. employees to qualify for local tax advantages. *See* PLR 8722031 (sub-plan for United Kingdom tax law purposes).

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III. Employee Stock Purchase Plans

A. Overview of Purchase Rights Under Employee Stock Purchase Plans

Employee stock purchase plans grant options (often called "purchase rights" to distinguish them from ISOs and NSOs) to employees to purchase stock of their employer (or an affiliate of their employer), generally at a discounted price and without payment of brokerage costs or other fees. The amount of the purchase price, the timing of the grant of the purchase right, and the timing of the exercise of the purchase rights are variables of these plans. If the requirements of §423 are met, employees receive many of the tax benefits under §421 that are available for ISOs.

Some employers sponsor stock offerings to employees at a stated price, and the employees may accept the offering and receive stock once they pay the offering price. Many employee stock purchase plans, however, provide that an employee may purchase shares only through payroll deductions (though the plan is not required to impose this restriction). In such plans, an employee's payroll deductions are used to purchase stock at a specified time (typically, every six months) at a price determined by reference to the price on the date of the offer and/or the date of the purchase. Payroll deductions that are insufficient to purchase a full share of stock may be carried over into the next offering period.

Probably the most important feature of an employee stock purchase plan (and the feature that clearly distinguishes it from an ISO plan) is that it can offer employees the right to purchase stock at a purchase price as low as the lesser of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value of the stock at the time of purchase,[347] while still providing many of the tax benefits of an ISO. Stock under an ISO plan, by contrast, must be purchased at a price that is at least 100% of fair market value on the date of grant of the option.[348]

Employee stock purchase plans are subject to lower limits on the maximum dollar amount of permitted purchases than ISO plans; and, unlike ISOs, the purchase rights under the plan must be available broadly to employees on uniform terms. The maximum period during which a purchase right under an employee stock purchase plan may be exercised is also shorter than the maximum period that an ISO may be exercised. By contrast, although ISOs share many of the same tax attributes, the employer's ability to differentiate among the awards available to individual employees allows ISOs to serve as more focused incentive awards.

Despite the limitations on employee stock purchase plans, they remain popular, especially among technology corporations, and many institutional shareholders and their advisors have more lenient policies with respect to approval of the share reserves necessary for such plans than for ISOs. Employee stock purchase plans promote broad-based employee ownership and the accounting expense associated with employee stock purchase plans, on a per share basis, is generally significantly lower than the expense associated with ISOs with an expected 10-year term.

In order for purchase rights to receive favorable tax treatment under §421(a), the employee stock purchase plan pursuant to which they are granted (and any offering under that plan) must satisfy the requirements in §423(b). To avoid confusion with the discussion of ISOs, and to conform to generally accepted terminology under §423 plans, unless context indicates that a reference to an "option" is more appropriate, an option granted under a §423 plan will be referred to as a "purchase right," the option price will be referred to as the "purchase price," and the period from the grant of the purchase right until it expires will be referred to as the "offering period."

The following is a summary list of the requirements under §423(b) (discussed in more detail below). The plan itself must satisfy the first two requirements.[349] If the plan fails to satisfy these requirements, the deficiency cannot be made up in the terms of an offering under the plan:

(1) Purchase rights may be granted only to employees of the employer corporation or its parent or subsidiary corporations to purchase stock in any such corporation.[350]

(2) The plan must be approved by the stockholders of the granting corporation within 12 months before or after adoption of the plan.[351]

In addition, the following requirements (also discussed in more detail below), must be satisfied either by the plan or by an offering made under the plan:

(3) Five-percent-or-more owners must be excluded from participation in the plan or offering.[352]

(4) All employees of the designated participating corporations must be eligible to participate, except that the employer is permitted to exclude from the plan four categories of employees: persons employed less than two years; part-time employees; seasonal employees; and highly compensated employees.[353]

(5) The same rights and privileges must be available to all participants granted purchase rights.[354]

(6) The purchase price of stock must be no less than the lesser of 85% of the stock's fair market value on the "date of grant"[355] of such purchase right or 85% of the stock's

[347] §423(b)(6); Reg. §1.423-2(g)(1).

[348] §422(b)(4); Reg. §1.422-2(e)(1).

[349] Reg. §1.423-2(a).

[350] §423(b)(1); Reg. §1.423-2(b).

[351] §423(b)(2); Reg. §1.423-2(c).

[352] §423(b)(3); Reg. §1.423-2(d). For purposes of this rule, the rules of §424(d) (relating to attribution of stock ownership) apply in determining stock ownership, and stock which the employee may purchase under outstanding options is treated as stock owned by the employee.

[353] §423(b)(4); Reg. §1.423-2(e).

[354] §423(b)(5); Reg. §1.423-2(a)(3)(iii), §1.423-2(f).

[355] As discussed below, the regulations provide that the date of grant will be the first day of an offering if the terms of the plan or offering designate either a maximum number of shares that may be purchased by each employee during the offering or a formula to establish such maximum. Unless the maximum number is fixed and determinable earlier, the date of grant will be deemed to occur on the purchase date.

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fair market value on the exercise date of such purchase right.[356] See III.B.6., below.

(7) If the purchase price is not less than 85% of the stock's fair market value on the exercise date, the offering period may not extend beyond five years from the date of grant. If the purchase price is determined in any other manner, the offering period may not extend beyond 27 months from the grant date.[357]

(8) A $25,000 annual accrual limit must apply to purchase rights under the plan.[358]

(9) Purchase rights must be nontransferable other than by will or the laws of descent and distribution and exercisable only by the participant during the participant's lifetime.[359]

An employee stock purchase plan that, together with any applicable offering under the plan, satisfies these nine requirements is referred to in the following discussion as a "§423 plan." An employee is not required to recognize income for federal income tax purposes when purchasing employer stock pursuant to a purchase right granted under a §423 plan. Instead, as in the case of an ISO, the employee recognizes income upon the later disposition of the stock. Unlike an exercise of an ISO, however, the employee is not required to recognize alternative minimum taxable income on the exercise of a purchase right under a §423 plan.[360]

The determination of whether a particular purchase right is considered to have been granted under a §423 plan is made on the date of grant. A purchase right with terms that are not consistent with the terms of the §423 plan or offering under which it was granted, is not treated as granted under a §423 plan.

If, contrary to the terms of the §423 plan or offering, a purchase right is granted to an ineligible individual, that purchase right will be treated as not having been issued under the §423 plan and thus will not be eligible for favorable tax treatment; however, other purchase rights granted to eligible employees pursuant to the terms of an otherwise qualified offering will not be disqualified.[361] Note that in the reverse scenario, in which an eligible employee who is entitled under a plan or offering to be granted a purchase right that satisfies the requirements of §423 is granted a purchase right that does not satisfy §423, unless the eligible employee is granted a purchase right under the plan or offering that satisfies §423, all of the purchase rights granted under the plan or offering would be disqualified.[362]

For purposes of §423 and the regulations, the term "stock" means capital stock of any class, including voting or nonvoting common or preferred stock.[363] Generally, the term includes both treasury stock and stock of original issue.[364] Special classes of stock authorized to be issued to and held by employees are considered stock, provided such stock otherwise possesses the rights and characteristics of capital stock.[365] For purposes of determining what constitutes voting stock in ascertaining whether a plan has been approved by stockholders under Reg. §1.423-2(c), or whether the limitations pertaining to voting power contained in Reg. §1.423-2(d) have been met, stock that does not have voting rights until the occurrence of an event, such as a default in the payment of dividends on preferred stock, is not voting stock until the occurrence of such event.[366] Generally, stock that does not possess a general voting power and may vote only on particular questions is not voting stock. If, however, such stock is entitled to vote on whether a stock option plan may be adopted, it is voting stock.[367] Ownership interests other than capital stock are generally considered stock.[368]

B. Requirements for a §423 Plan

1. Participation in the §423 Plan

a. Employees Only

Only employees of the corporation sponsoring the plan and/or employees of its designated parent or subsidiary corporations may participate in a §423 plan.[369] The plan must specifically limit participation to such employees, or the plan is not a §423 plan and any of the purchase rights granted thereunder will not be entitled to favorable tax treatment under §421(a).[370] Whether an individual is considered an employee is determined using the same rules as are applied for ISO purposes.[371]

b. Exclusion of 5% Owners

A §423 plan or offering must provide that an employee who, after grant of a purchase right under the §423 plan, would own stock possessing 5% or more of the total combined voting power or value of all classes of stock of the employer sponsoring the §423 plan or of any of its affiliates, may not be granted

[356] §423(b)(6); Reg. §1.423-2(g).
[357] §423(b)(7); Reg. §1.423-2(h).
[358] §423(b)(8); Reg. §1.423-2(i).
[359] §423(b)(9); Reg. §1.423-2(j).
[360] While §56(b)(3) specifically addresses incentive stock options (as defined in §422), there is nothing in §56 that subjects the exercise of purchase rights under a §423 plan to the alternative minimum tax regime.
[361] Reg. §1.423-2(a)(4). In an example given in the regulations, the §423 plan provides that purchase rights may be granted under the plan only to employees of the corporation, but the corporation granted a purchase right to a consultant. In that example, the purchase right granted to the consultant does not qualify as a purchase right under a §423 plan, but it also does not disqualify the purchase rights to the corporation's employees. Reg. §1.423-2(a)(5) *Ex.* 2.
[362] Reg. §1.423-2(a)(4). *See, e.g.*, Reg. §1.423-2(a)(5) *Ex.* 1.
[363] Reg. §1.421-1(d)(1).
[364] Reg. §1.421-1(d)(1).
[365] Reg. §1.421-1(d)(1).
[366] Reg. §1.421-1(d)(2).
[367] Reg. §1.421-1(d)(2).
[368] Reg. §1.421-1(d)(3). *See also* PLR 199931005 and PLR 9243026, in which the IRS ruled that American depository shares were "stock" for purposes of §421. The American depository shares, which represented the ordinary shares of a U.K. parent of U.S. subsidiaries, were evidenced by American depository receipts, and were traded on the New York Stock Exchange.
[369] §423(b)(1); Reg. §1.423-2(b). See PLR 200547007 for discussion of employee stock purchase plan requirements under §423(b). See also PLR 200112021, in which the IRS ruled that employees of a single-member LLC owned by a subsidiary corporation of the granting corporation were eligible for participation in the granting corporation's §423 plan, provided that the subsidiary corporation and parent corporation qualified under the rules of §424(e) and §424(f). *See also* III.A., above. If, contrary to the terms of the §423 plan or offering, a purchase right is granted to an ineligible individual (e.g., a non-employee), that purchase right will be treated as not having been issued under the §423 plan and thus it will not be eligible for favorable tax treatment; however, other purchase rights granted to eligible employees pursuant to the terms of the otherwise qualified offering will not be disqualified.
[370] Reg. §1.423-2(b).
[371] Reg. §1.423-2(b) (cross-referencing Reg. §1.421-1(h)). *See* II.B.1.a., above.

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an option under the plan.[372] In determining whether an employee is a 5% owner:

(1) All stock options that the employee has outstanding (including purchase rights under an employee stock purchase plan) are considered as stock held by the employee, regardless of whether such options are ISOs or whether such options are exercisable currently.[373]

(2) Only shares that are issued and outstanding immediately after the grant of the purchase right are taken into account in determining the aggregate number of shares of stock outstanding. Any treasury shares or shares that are to be issued pursuant to outstanding stock options are not counted.[374]

Example: If a corporation with 100,000 shares issued and outstanding attempts to grant an employee an option for 5,000 shares under its employee stock purchase plan, no part of the grant will be treated as being under the employee stock purchase plan because the employee would be a 5% owner immediately after the grant. The grant of the option for 5,000 shares causes the employee to be treated as the owner of the 5,000 shares for purposes of determining 5% ownership. By contrast, the grant of the option does not increase the number of shares issued and outstanding, which remains at 100,000 following the grant of the option. Therefore, even if the employee being granted the option did not hold any stock or options in the corporation prior to the grant, the employee would be treated as a 5% owner as a result of the grant.[375]

c. *Permitted Exclusions from Participation*

A §423 plan or offering must provide that purchase rights are to be granted to all employees of any corporation whose employees are granted any of such purchase rights by reason of their employment by that corporation.[376] Certain employees, however, may be excluded from participation in the §423 plan, as follows:[377]

- employees who have been employed fewer than two years;
- employees whose customary employment is 20 hours or less per week;
- employees whose customary employment is for not more than five months in any calendar year;[378] and
- highly compensated employees (as defined in §414(q)).[379]

In addition, the regulations permit the exclusion of employees who are citizens or residents of a foreign jurisdiction if the grant of a purchase right under the plan or offering to such person is prohibited under the laws of such jurisdiction or if compliance with the laws of such foreign jurisdiction would cause the plan or offering to violate the requirements of §423.[380]

Note that while these permitted exclusions are similar in certain respects to the §410(b) permitted exclusions from coverage under tax-qualified retirement plans, there are important differences between the coverage rules under §423 and those under §410(b). It appears that employees who are subject to a collective bargaining agreement must be covered under a §423 plan, whereas such employees may be excluded from consideration under §410(b) by virtue of §410(b)(3)(A).[381] Other groups of employees that may be excluded under §410(b) also apparently must be covered in any §423 plan that the employer sponsors.[382] Nor is there any analog under §423 to the ratio percentage test or nondiscriminatory classification test under §410(b). If the terms of an employee stock purchase plan or offering exclude any employees (other than those employees that are permissible to exclude under the statute and regulations), then none of the purchase rights granted under such offering will be treated as being granted under a qualified §423 plan.[383] Thus, the inadvertent exclusion of one or more employees can pose a risk to the §423 plan's qualification.[384]

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[372] §423(b)(3), cross-referencing the stock ownership rules of §424(d). Reg. §1.423-2(d).

[373] Reg. §1.423-2(d)(1).

[374] Reg. §1.423-2(d)(2).

[375] Reg. §1.423-2(d)(3) *Exs.* 3 and 4.

[376] §423(b)(4); *see also* Reg. §1.423-2(e)(1). Note that with most ESPPs, the employee elects to participate by agreeing to payroll withholding. Those electing not to participate are not actually granted a purchase right. The regulations provide, however, that a plan, which by its terms permits all eligible employees to elect to participate in an offering, will not violate this requirement merely because eligible employees elect not to participate in the offering and thus are not actually granted purchase rights.

[377] §423(b)(4); Reg. §1.423-2(e)(1). The IRS declined to expand this group to include nonresident aliens who receive no earned income that constitutes income from sources within the United States or employees under a specified age (like the age of majority). While the IRS recognized that there are often complexities associated with the inclusion of such persons, it noted that §423 does not specifically permit such exclusion and thus that it was constrained by the statutory authority. Preamble to T.D. 9471, 74 Fed. Reg. 59,074, 59,076 (2009).

[378] Reg. §1.423-2(e)(2) permits a plan or offering to exclude employees who have completed a shorter period of service or whose customary employment is for fewer hours per week or fewer months in a calendar year than specified here, provided that the exclusion is applied in an identical manner to all employees of every corporation whose employees are granted purchase rights under the plan or offering.

[379] This group generally includes employees who either (1) are 5% owners at any time in the current or prior year, or (2) earned more than a specified dollar amount (subject to annual adjustments) from the employer in the prior year. For the current and previous dollar amounts, see Worksheet 1 in 371 T.M., *Employee Plans — Deductions, Contributions and Funding.* The employer may elect to limit the group earning in excess of this dollar amount who are treated as highly compensated employees to those who are in the top 20% of employees ranked by compensation in the preceding year. §414(q)(1)(B)(ii), §414(q)(3). While the IRS declined to expand this exclusion to permit a corporation to exclude a subset of highly compensated employees (HCEs) on any basis, the regulations do authorize the exclusion of HCEs (1) with compensation above a certain level, or (2) who are officers or subject to the disclosure requirements of §16(a) of the Securities Exchange Act of 1934, provided that the exclusion is applied in an identical manner to all HCEs of every corporation whose employees are granted purchase rights under the offering. Reg. §1.423-2(e)(2).

[380] Reg. §1.423-2(e)(3).

[381] *See* Reg. §1.423-2(e)(1).

[382] *Compare* §410(b)(3) *with* §423(b)(4) *and* Reg. §1.423-2(e)(1). Thus, for example, an employer cannot simply exclude collectively bargained employees, nonresident alien employees, or employees under a specified age from its §423 plan. Also, a plan that wishes to exclude only certain sub-groups of highly compensated employees has only limited flexibility to do so.

[383] Reg. §1.423-2(e)(4).

[384] See, however, PLR 200547007, which concluded that a plan amendment excluding non-employees who may subsequently be determined to be common law employees does not violate §423, provided that each excluded individual (1) has worked for the corporation for less than two years, (2) customarily works 20 hours per week or less, (3) customarily works for not more than five

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This issue can arise, for example, if a corporation establishes or acquires a foreign entity that is treated like a corporation under foreign laws but is a disregarded entity for United States income tax purposes. Because the foreign entity is a disregarded entity, its employees are treated as if they are employees of the parent for U.S. tax purposes.[385] As a result, the corporation must include the foreign entity's employees that meet the eligibility criteria in the next offering under its plan in order for such offering to qualify for favorable tax treatment under §423. If the corporation excludes these foreign employees, then all purchase rights issued in such offering to the corporation's eligible U.S. employees will be disqualified.

2. Stockholder Approval of the §423 Plan

A §423 plan must be approved by the stockholders of the granting corporation within 12 months before or after the plan is adopted by the corporation's board of directors.[386] A §423 plan, as adopted and approved, must specifically state:

- the aggregate number of shares that can be issued under the plan,[387] and
- the corporations, or class of corporations, whose employees will be offered purchase rights under the plan.[388]

Once a §423 plan is approved by the stockholders of the granting corporation, the plan need not be reapproved unless the plan is amended or changed in a manner that is considered to be the adoption of a new plan, in which case the plan (or, in the case of a share increase, the portion of the plan relating to the additional shares) must be reapproved within the prescribed 24-month period. An increase in the number of shares to be issued under the plan (other than an increase merely reflecting a change in the number of outstanding shares, such as a stock dividend or stock split) is a change requiring stockholder approval. The same rule applies to a change in the corporations with employees who are offered purchase rights under the plan, unless the plan provides that designations of participating corporations may be made from time to time from among a group consisting of the granting corporation and its parent or subsidiary corporations.[389] If the plan provides for such designations, the group from among which such changes and designations are permitted without additional stockholder approval may include corporations that become parents or subsidiaries of the granting corporation after adoption and approval of the plan.[390] A change in the granting corporation of the stock available for purchase under the plan is considered the adoption of a new plan requiring stockholder approval. Any other changes in the terms of an employee stock purchase plan are not considered the adoption of a new plan and, thus, do not require stockholder approval.[391]

Stockholder approval of increases in the number of shares that may be issued under a §423 plan can be cumbersome. For this reason, some corporations have included "evergreen" provisions in the share reserves of their §423 plans. Under such a provision, the share reserve is automatically adjusted (usually annually) by a fixed number of shares, by some percentage of either the outstanding shares of common stock on some measurement date (for example, the last trading day of the corporation's fiscal year), or by some percentage of the initial share reserve. Because of the requirement that stockholders approve the aggregate number of shares that may be issued under a §423 plan, the evergreen provision must be phrased to allow the computation, as of the date of stockholder approval, of the maximum number of shares issuable under the plan.[392] This can be accomplished, for example, by stating the overall maximum number of shares that may be added to the reserve over the fixed duration of the §423 plan or the maximum number of shares that may be added to the plan on an annual basis over the fixed duration of the §423 plan. Unlike ISOs, purchase rights under §423 need not be made pursuant to a plan with a fixed duration. Therefore, if an evergreen provision is used, care should be taken to ensure that the stockholders will be able to calculate the maximum number of shares issuable under a plan.

3. Same Rights and Privileges but Permitted Limitations on the Extent of Employee Participation

A §423 plan or offering must provide that all employees granted purchase rights under the plan or offering have the same rights and privileges.[393] The determination of whether the

months in a calendar year, or (4) is a highly compensated employee (within the meaning of §414(q)).

[385] *See, e.g.*, PLR 200046013. The same issue can arise if a corporation establishes or acquires a domestic entity that is disregarded as a separate entity for U.S. tax purposes.

[386] §423(b)(2); Reg. §1.423-2(c). The requirements for stockholder approval are the same as the requirements for stockholder approval of ISOs. *See* II.B.1.b., above.

[387] Reg. §1.423-2(c)(3). A plan that merely provides that the number of shares that may be issued under the plan may not exceed a stated percentage of the shares outstanding at the time of each offering or grant under the plan does not satisfy this requirement.

[388] Reg. §1.423-2(c)(3).

[389] Reg. §1.423-2(c)(3), §1.423-2(c)(4). Under Reg. §1.423-2(c)(5) *Ex.* 1, new stockholder approval is required if there is a change in the underlying shares or a change in the granting corporation; for instance, if a plan is amended to provide for purchase rights to acquire a parent corporation's stock rather than a subsidiary corporation's stock. Reg. §1.423-2(c)(5) *Ex.* 3, provides guidance on applying the stockholder approval requirement if a plan is assumed in connection with a corporate transaction. In PLR 9245020, the IRS ruled that the designation of a newly acquired subsidiary as the sole corporation whose employees would be granted purchase rights under the §423 plan during a special purchase period was not the adoption of a new §423 plan and, consequently, did not require stockholder approval. *See also* PLR 9444019.

[390] Reg. §1.423-2(c)(4).

[391] Reg. §1.423-2(c)(4). *See* Rev. Rul. 78-326; PLR 200418020 (proposed amendments to employee stock purchase plan that did not provide additional benefits to plan participants were not modifications under §424(h)(3) and, thus, did not require stockholder approval under §423(b)(2) because no new plan was created). *See also* New York Stock Exchange Listed Company Manual, ¶303A.08, *available at* https://nyseguide.srorules.com/listed-company-manual (excluding §423 plans from requirement for shareholder approval for "material revisions" to an equity compensation plan); NASDAQ Marketplace Rule 5635(c)(2), *available at* http://business.nasdaq.com/list/Rules-and-Regulations (excluding §423 plans from requirement for shareholder approval for material amendment to equity compensation plan).

[392] Reg. §1.423-2(c)(3). *See also* Reg. §1.423-2(c)(5) *Exs.* 4 and 5; PLR 9531031 (approving ISO plan evergreen share reserve). For an example of such an evergreen provision, see the Worksheets.

[393] §423(b)(5); Reg. §1.423-2(a)(3)(iii), §1.423-2(f). In PLR 201911002, the provisions of an ESPP and related enrollment documents allowed participants to obtain loans from the employer or a third party to purchase shares, unless the loans would be prohibited by §402 of the Sarbanes-Oxley Act. The PLR concluded that the ESPP did not violate §423(b)(5), even though some participants might not be able to obtain the loans due to the Sarbanes-Oxley Act.

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terms of an offering satisfy this requirement is made on an offering-by-offering basis. Under this offering-by-offering approach, a corporation may establish separate offerings under its plan with different terms where each such offering (taken on its own) is designed to qualify under §423.[394]

Note: The final rules clarify that one or more separate offerings may be made under a §423 plan at the same time, and these separate offerings may contain different rights and privileges (e.g., discount percentages) and exclude different groups of employees in each offering, so long as the terms of each offering (together with the plan) independently satisfy the requirements of the final rules.[395] For example, a parent corporation may have different offerings for different subsidiaries participating in its §423 plan. The parent could designate which subsidiaries may participate in a particular offering and provide a different discount percentage and exclusions for each offering.[396] This flexibility allowed by the rules makes sense, as a parent need not include all subsidiaries in its §423 plan. This clarification provides companies with significant design flexibility to use multiple offerings with different terms regarding discount, eligibility, payment method, or other features. In particular, this flexibility is helpful when managing grants to employees of subsidiaries in foreign jurisdictions, to employees of different subsidiaries, or to employees of a newly acquired subsidiary.

The determination of purchase price, payment provisions, and all other provisions must be uniform for all employees of the corporation who are offered purchase rights under the plan or offering, with limited exceptions.[397] For example, a plan or offering, in order to comply with the laws of a foreign jurisdiction, may provide terms less favorable to employees who are citizens or residents of such jurisdiction than are provided to employees who are residents of the United States.[398] In addition, a §423 plan or offering may limit the amount of stock subject to purchase rights to a specified dollar amount or to a certain percentage of total compensation, or the basic or regular rate of compensation, of all employees.[399]

4. *$25,000 Annual Accrual Limitation on Grants of Purchase Rights*

A §423 plan or offering must provide that no employee can accrue the right to purchase stock of the employer corporation (and its parent or subsidiary corporations) at a rate that exceeds $25,000 of the fair market value of such stock (determined when the purchase right in question was granted) for each calendar year for which the purchase right is outstanding.[400] While the right to purchase stock under a purchase right *accrues* when the purchase right (or any portion thereof) first becomes exercisable during a calendar year,[401] the limit increases by $25,000 for each calendar year during which the purchase right is outstanding.[402] Thus, for example, an employee may purchase $50,000 worth of stock (determined based on the stock's fair market value at the date of grant) under an offering that begins in Year 1, but for which the first (and only) purchase date[403] does not occur until Year 2.[404]

All §423 plans and offerings of the employer and any other corporations in the parent/subsidiary chain of the employer must be included in applying the $25,000 limit.[405] ISOs and NSOs are not included in the $25,000 limit, nor are purchase rights granted under an employee stock purchase plan that does not qualify as a §423 plan.[406]

As provided in Reg. §1.423-2(i)(4), the $25,000 limit is applied in accordance with the following rules:

- An employee may purchase up to $25,000 worth of stock (based on its fair market value when the purchase right was granted) in each calendar year during which the purchase right was outstanding under the §423 plan.
- Alternatively, if an offering period spans more than one calendar year, by carrying forward any unused portion of the $25,000 limit from one calendar year to the next, an employee may purchase more than $25,000 of stock in a calendar year (again, based on its fair market value at date of grant of the purchase right), so long as the total amount of stock that the employee purchases does not exceed $25,000 in fair market value (determined at date of grant) for each calendar year in which the purchase right was outstanding. An employee, however, may not purchase stock in anticipation that the purchase right will be outstanding for some future year. Rather, the employee may purchase only the amount of stock that does not exceed the $25,000 limit for the year of the purchase and for preceding years during which the purchase right was outstanding.
- The amount of stock that an employee may purchase under a §423 plan may not be increased because of the corporation's failure to grant a purchase right in an earlier year under the plan or because of the employee's failure to purchase stock under an earlier purchase right.
- If a purchase right granted under a §423 plan is outstanding in more than one calendar year, stock purchased pursuant to the purchase right will be applied first, to the

[394] Reg. §1.423-2(f)(7) *Ex.* 5.

[395] Preamble to T.D. 9471, 74 Fed. Reg. 59,074, 59,075 (2009).

[396] Reg. §1.423-2(f)(7) *Ex.* 5, §1.423-2(e)(6) *Ex.* 8.

[397] §423(b)(5); Reg. §1.423-2(a)(3)(iii), §1.423-2(f).

[398] Reg. §1.423-2(f)(4). Note, however, that the plan or offering could not provide terms that are more favorable to employees who are citizens or residents in such foreign jurisdiction than are provided to employees who are residents of the United States.

[399] §423(b)(5); Reg. §1.423-2(f)(2), §1.423-2(f)(7) *Ex.* 1.

[400] §423(b)(8); Reg. §1.423-2(i)(1), §1.423-2(i)(4).

[401] §423(b)(8)(A); Reg. §1.423-2(i)(1)(i).

[402] In the preamble to the final regulations, T.D. 9471, 74 Fed. Reg. 59,074, 59,076–59,077 (2009), the IRS noted that the application of this rule had been interpreted inconsistently by employers. Many employers took the position that, for example, an employee may purchase $50,000 worth of stock (determined based on the stock's fair market value at the date of grant) under an offering that begins in Year 1, but for which the first purchase date does not occur until Year 2. Other employers took the position that an employee in the above example may only purchase $25,000 worth of stock (determined based on the stock's fair market value at the date of grant). The proposed regulations supported the second interpretation (in Prop. Reg. §1.423-2(i)(4)). The IRS reconsidered, however, and the final regulations support the first interpretation: that the limitation is applied for each calendar year in which the purchase right is outstanding.

[403] A purchase date generally refers to a date the purchase right may be exercised.

[404] Reg. §1.423-2(i)(5) *Ex.* 5.

[405] §423(b)(8); Reg. §1.423-2(i)(1).

[406] Reg. §1.423-2(i)(3).

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extent allowable under §423(b)(8) and Reg. §1.423-2(i), against the $25,000 limit for the earliest year in which the purchase right was outstanding, and then against the $25,000 limit for each succeeding year, in order.

The regulations provide an example of the last rule, discussed above, in the case of an employee who purchases $60,000 in stock by exercising a purchase right granted under a §423 plan.[407] The example explains that if this purchase right were outstanding in three calendar years, then $25,000 in fair market value of such stock (determined when the purchase right was granted) would be attributed to the first calendar year in which the purchase right was outstanding, another $25,000 would be attributed to the second calendar year, and the remaining $10,000 would be attributed to the third calendar year. Thus, the employee could receive a purchase right under another offering under the plan entitling the employee to purchase an additional $15,000 of stock for the third calendar year.

The following example further illustrates how this "cumulative" $25,000 limit applies:

> *Example:* On July 1, 2019, B, an employee of X Corp., is granted rights under X Corp.'s §423 plan to purchase a maximum of 750 shares of X Corp. stock at the lesser of 85% of the stock's fair market value on the date of grant (July 1, 2019) or 85% of the stock's fair market value on the date of purchase, with automatic purchase dates occurring on June 30, 2020 and June 30, 2021. The fair market value of X Corp. stock on July 1, 2019, is $100 per share. B may purchase up to 500 shares on June 1, 2020. On June 30, 2021, B may purchase another 250 shares, plus the number of shares equal to 500 minus the number of shares purchased in 2020. The granting of the 750 purchase rights to B will be treated as a grant under a §423 plan because in each calendar year in which the purchase rights were outstanding, there will be no purchase rights outstanding for more than the $25,000 limit per year plus the outstanding unused $25,000 limit for the previous years.
>
> Suppose, however, that on January 1, 2020, Y Inc., a wholly owned subsidiary of X Corp., also maintains a §423 plan and grants B 100 rights to purchase, on December 31, 2020, shares of X Corp. stock at $127.50 per share, and that the fair market value of X Corp. stock on the date of grant of these purchase rights was $150 per share. The grant of 100 purchase rights under the Y Inc. plan will not be considered the grant of purchase rights under a §423 plan, because in 2020 when the purchase rights become outstanding, B already has purchase rights under the X Corp. plan that use all of the $25,000 limit.

5. *Stated Limit on Number of Shares Purchasable Under a §423 Plan*

As discussed in II.B.1.d., above, an ISO is considered "granted" once the employer completes the corporate action constituting an offer of stock for sale necessary under the terms and conditions of the ISO.[408] The corporate action constituting an offer of stock for sale is not considered complete, for purposes of the ISO rules, until the date on which the maximum number of shares that can be purchased under the option and the minimum option price is fixed or determinable.[409]

By contrast, it is not necessary that the minimum option price be "fixed and determinable" on the date of grant of a purchase right under a §423 plan.[410] Thus, a corporate action constituting an offer under a §423 plan may occur at the commencement of the offering even if, for example, the exercise price is defined as the lesser of 85% of the fair market value at grant or 85% of the fair market value at exercise (so that the minimum price cannot be determined until exercise).

The requirement that the maximum number of shares be fixed or determinable on the date of grant, however, applies to purchase rights under a §423 plan or offering. Accordingly, the regulations provide that the date of grant of a purchase right under a §423 plan will be the first day of an offering if the terms of the plan or offering designate either a maximum number of shares that may be purchased by each employee during the offering or a formula to establish such maximum on the first day of the offering.[411] Otherwise, unless the maximum number of shares is fixed and determinable earlier, the date of grant will be deemed to occur on the purchase date.[412] No particular number of shares is necessary to satisfy the requirement to designate a maximum number of shares that may be purchased during the offering in order to establish the first day of the offering period as the date of grant for the option. The designation of any maximum number of shares is sufficient.[413]

In addition to being used to calculate the ordinary income resulting from qualifying dispositions and the two-year holding period required to avoid a disqualifying disposition, the date of grant of a purchase right under a §423 plan has particular significance. On the date of grant, the plan must meet many of the requirements of §423(b) (e.g., the requirements that all eligible employees be entitled to participate, that 5% owners be excluded from participation, that the purchase price be not less than the lesser of 85% of the stock's fair market value on the date of grant or the exercise date, and that no employee accrue the right to purchase stock at a rate that exceeds $25,000).

Note that even if the purchase price of a purchase right under a §423 plan or offering is determined solely by reference to the purchase date price, there still may be advantages to the employees to have the date of grant be the first day of an offering. First, the earlier date of grant will start one of the statutory holding periods for the purchased shares. Second, because the ordinary income on a qualifying disposition is based on the date of grant discount, where there is no date of grant discount the employee will be able to avoid any ordinary income on a qualifying disposition.

The maximum number of shares purchasable by an individual under the plan may be established as of the first day of the offering period by, for example, specifying a fixed maximum (such as 500 shares) or by a formula. One such formula

[407] Reg. §1.423-2(i)(5) *Ex.* 3.

[408] Reg. §1.421-1(c)(1).

[409] Reg. §1.421-1(c)(1).

[410] Reg. §1.421-1(c)(1); Reg. §1.423-2(h)(2).

[411] Reg. §1.423-2(h)(3).

[412] §1.423-2(h)(3).

[413] Reg. §1.423-2(h)(3); preamble to T.D. 9471, 74 Fed. Reg. 59,076 (2009). Thus, for example, the maximum number of shares could be the plan's entire initial share reserve.

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would be to divide $25,000 by the fair market value of the issuing corporation's stock on the first day of the offering period.[414] By contrast, if the purchase price is defined as the lesser of the price on the first day of the offering period or the last day of the offering period (when the purchase rights can be exercised), and the maximum number of shares purchasable by an individual is defined as $25,000 divided by the purchase price, the date of grant does not occur until the last day of the offering (because the maximum number of shares purchasable is not fixed or determinable until that date).[415]

6. Purchase Price of the Stock

A §423 plan or offering must provide that the purchase rights under a §423 plan have a purchase price that is no less than the lesser of the following:

- 85% of the stock's fair market value at the time the purchase right is granted; or
- 85% of the stock's fair market value at the time the shares are purchased.[416]

If a purchase right granted under a stock purchase plan does not meet the above pricing rule, the purchase right will not be treated as having been granted under a §423 plan. Further, if the terms of an offering under a stock purchase plan do not meet this pricing rule, all purchase rights granted under that offering will be treated as not having been granted under a §423 plan.[417] This can be of particular concern where the plan or offering does not contain a maximum number of shares (either as a number or as a formula) that may be purchased by each employee during the offering. As discussed in III.B.5., above, the regulations provide that, unless the maximum number is fixed and determinable earlier, the date of grant will be deemed to occur on the purchase date.[418] If the purchase price is determined by reference to the first date of an offering (e.g., 85% of the stock's fair market value on the first day of the offering), but the date of grant is deemed to occur later, the requirement contained in §423(b)(6) will not be satisfied.[419]

The purchase price may be stated as a dollar amount or as a percentage of the fair market value of the corporation stock.[420] If the purchase price is stated as a dollar amount, such amount must be not less than 85% of the fair market value of the stock at the time the purchase right is granted.[421] If the purchase price is stated as a dollar amount that is less than 85% of such fair market value, then the purchase right will not be treated as being granted under a §423 plan, regardless of whether the purchase price of the stock is at least 85% of the fair market value of the stock at the time of exercise.[422]

> *Example:* X Corp.'s stock purchase plan grants purchase rights to all X Corp. employees to purchase X Corp. stock at $85 per share. If the price of X Corp. stock at the date of grant is above $100 per share, the purchase rights are not considered to be granted under a §423 plan, even if the fair market value of X Corp. stock drops to $100 or less at the time an employee exercises the purchase rights.

Practice Insight: The §423 plans of many corporations, particularly those in the technology sector of the economy, make use of so-called "look-back" pricing, under which the purchase price is 85% (or a higher percentage) of the fair market value on the date of grant or the date of exercise, whichever is lower. In a stock market that is rising, this serves to lock in a lower purchase price for the duration of the offering period, typically 24 months with purchase dates every six months. In a declining market, the plan may provide for the commencement of a new offering period of 24 months (or less) if the fair market value of the corporation's stock on a purchase date is less than the fair market value of the corporation's stock on the offering date, subject to compliance with the $25,000 accrual limit.[423]

7. Offering Period

If the purchase price under a §423 plan is at least 85% of the fair market value of the corporation stock at the time the purchase right is exercised, then a §423 plan or offering must provide that the offering period is no longer than five years from the date of grant of the purchase right.[424] If the purchase price is determined in any other manner, such as a flat dollar amount, a percentage (not less than 85%) of the date of grant fair market value, or 85% (or a higher percentage) of the lesser of date of grant and purchase date fair market values, then a §423 plan or offering must provide that the offering period is no longer than 27 months from the date of its grant.[425] The §423 plan, or any separate offering document thereunder, must specifically provide for these offering periods. Otherwise, any purchase rights granted thereunder will not be considered to be made under a §423 plan regardless of whether the particular purchase right provides for exercise in the appropriate time period.[426]

8. Restrictions on Transfer

A §423 plan must provide that purchase rights may not be transferable other than by will or the laws of descent and distribution.[427] The purchase rights may be exercisable, during the

[414] Reg. §1.423-2(h)(4) *Exs.* 3 and 4.

[415] Reg. §1.423-2(h)(4) *Ex.* 2.

[416] §423(b)(6); Reg. §1.423-2(g)(1). Reg. §1.423-2(g)(2) provides that the purchase price may be determined in any reasonable manner, including the valuation methods permitted under Reg. §20.2031-2 (estate tax regulations), so long as it meets the minimum pricing requirements.

[417] Reg. §1.423-2(g)(2).

[418] Reg. §1.423-2(h)(3).

[419] For example, assume that the offering date fair market value is $10 per share and the purchase price is equal to 85% of the lower of (i) the offering date fair market value or (ii) the purchase date fair market value. Assume further that neither the plan nor the offering contains the maximum share limit necessary to have the first day of the offering serve as the "grant date." Finally, assume that purchase date fair market value is $11 per share. Because the purchase price is equal to 85% of the offering date fair market value ($8.50), it is less than the statutory minimum permitted by §423(b)(6) (i.e., 85% of $11 = $9.35). As such, the offering violates §423(b)(6), and all purchase rights granted under that offering will be treated as not having been granted under a §423 plan.

[420] Reg. §1.423-2(g)(3).

[421] Reg. §1.423-2(g)(3).

[422] Reg. §1.423-2(g)(3).

[423] See the Worksheets for a sample employee stock purchase plan offering document that uses such method of pricing.

[424] §423(b)(7); Reg. §1.423-2(h)(1).

[425] §423(b)(7); Reg. §1.423-2(h)(1).

[426] Reg. §1.423-2(h)(1).

[427] §423(b)(9); Reg. §1.423-2(j).

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employee's lifetime, only by the employee.[428] The rules regarding restrictions on transfer are the same as the rules discussed in II.C.4., for ISOs.

9. Other Permitted Plan Provisions

A §423 plan, like an ISO plan, may contain additional terms to the extent that they do not contravene any of the Code's requirements for §423 plans. These additional terms, for example, could deal with the timing of grants of purchase rights, the method of payment of the purchase price, and the limitations on when purchase rights may be exercised.[429] For example, in PLR 200102042, the employer retained a right to repurchase shares from employees who purchased shares under a §423 plan, in the event the employees attempted to dispose of the shares before the expiration of the holding periods contained in §423(a)(1).[430] The IRS ruled that the plan satisfied the requirements of a §423 plan.

C. Taxation of Employee

1. Exercise of Purchase Right

There are no income tax consequences to an employee upon the grant of a purchase right under a §423 plan or upon the exercise of such right.[431] As discussed in III.A., above, unlike the exercise of an ISO, the employee also does not recognize alternative minimum taxable income on the exercise of a purchase right under a §423 plan.[432] The same rules apply if the option is exercised after the death of the employee by the estate or by a person who acquires the right to exercise the option by bequest or inheritance or by reason of the employee's death.[433]

If the requirements of §423 are not met, or if the employee terminates their employment with the employer more than three months before the exercise of the purchase right, then pursuant to §83, the employee will recognize as ordinary income the excess of the fair market value of the stock on the date of exercise over the purchase price.[434]

2. Disposition of Acquired Stock

The tax implications of the employee's disposition of stock acquired upon the exercise of a purchase right granted pursuant to a §423 plan will depend on whether the employee disposes of the stock before or after the statutory holding period has been met. The applicable holding period is the later of (1) two years from the date of grant of the purchase right, and (2) one year from the date of exercise of the purchase right.[435] The rules regarding when the transfer of stock is considered a disposition are the same as for ISOs.[436]

An eligible person (as defined in §1043(b)(1)) who sells, pursuant to a certificate of divestiture (as defined in §1043(b)(2)), shares of stock acquired pursuant to the exercise of a statutory stock option for purposes of complying with federal conflict of interest rules is treated as satisfying the statutory holding period requirement of §423(a)(1) regardless of how long the stock was held.[437]

a. Disposition After Holding Period Expires

If an employee sells or otherwise disposes of stock acquired through the exercise of a purchase right after the expiration of the statutory holding period, and the employee satisfies the employment requirements described below, i.e., a qualifying disposition, then in the year of the qualifying disposition, the employee recognizes ordinary income equal to the lesser of: (1) the excess of the fair market of the stock over the exercise price of the purchase right, with both the fair market value and the exercise price determined as of the date of grant, and (2) the excess of the amount realized on the disposition of the stock over the price paid on the exercise of the purchase right.[438] The income from the application of this rule is included in the employee's gross income for the taxable year in which the disposition occurs.[439] If the option price is not fixed or determinable at the time the option is granted, the option price is computed as if the option had been exercised at grant. Notwithstanding the inclusion of an amount as compensation in the gross income of an employee, no deduction under §162 is allowable at any time to the employer corporation or a related corporation with respect to such amount.[440] Any additional gain or loss recognized on the disposition of the stock will be long-term capital gain or loss to the employee.

For purposes of this rule, the employee satisfies the employment requirements if, at all times beginning on the date of grant and ending on the day that is three months before the date of exercise, the employee is employed by:

- the employer whose stock is subject to the purchase right;
- an employer substituting or assuming the purchase right by reason of a corporate transaction that satisfies the requirements of §424(a); or

[428] §423(b)(9); Reg. §1.423-2(j).

[429] §423(b). See the Worksheets for a sample employee stock purchase plan and, in particular, §4 (dealing with grants of purchase rights) and §7 (dealing with participation, withdrawal and termination).

[430] The "repurchase right" was at the lower of the employee's exercise price or the fair market value at the time of repurchase.

[431] §421(a)(1).

[432] While §56(b)(3) specifically addresses incentive stock options (as defined in §422), there is nothing in §56 that subjects the exercise of purchase rights under a §423 plan to the alternative minimum tax regime.

[433] §421(c); Reg. §1.421-2(c).

[434] *See* §423(a); Reg. §1.421-1(h). For a discussion of §83 and the regulations thereunder, including a discussion of the §83(b) election, see 384 T.M., *Restricted Property — Section 83.* In addition, it is possible that pursuant to §409A, the employee would need to include additional amounts. In *Sutardja v. United States,* 109 Fed. Cl. 358 (2013), one of the first court cases to address the application of §409A to stock options, the Court of Federal Claims confirmed that *discounted* stock options constituted nonqualified deferred compensation for purposes of §409A. Discounted stock options, however, are typically created inadvertently and therefore not designed to comply with §409A (e.g., no fixed exercise date due to the fact that the option allows the holder to determine when to exercise and recognize taxable income). More significantly, a non-compliant discounted stock option will subject the optionee to accelerated income recognition upon vesting (as opposed to upon exercise), an additional 20% income tax, as well as an additional interest penalty. For a discussion of the tax treatment of discounted stock options, see 383 T.M., *Nonstatutory Stock Options.*

[435] §423(a)(1).

[436] *See* II.C.7., above.

[437] §421(d).

[438] §423(c).

[439] Reg. §1.423-2(k)(1)(ii).

[440] Reg. §1.423-2(k)(1)(iii).

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• a parent or subsidiary[441] of a corporation described above.[442]

The rules for determining whether an employee satisfies the employment requirements, including the rules for determining whether a substitution or assumption by reason of a corporate transaction satisfies §424(a), are the same as the rules for ISOs.[443]

Example (1): On January 1, 2018, all employees of X Corp. were granted rights to purchase a maximum of 250 shares of X Corp. stock at 85% of the stock's fair market value as of the date of grant. B exercised 10 purchase rights on the date of grant when X Corp. stock had a fair market value of $100 per share. B holds the X Corp. stock for five years and sells all her shares for $200 per share. In 2023, B recognizes $150 in ordinary income (the lesser of (1) the excess of the $100 fair market value of the stock on date of grant over the $85 exercise price multiplied by 10 shares, and (2) the excess of the amount realized on the disposition ($200) over the exercise price ($85) multiplied by 10 shares). The amount of capital gain on the sale of the stock is $1,000 ($200 sales price minus the adjusted basis of the stock ($85 purchase price plus $15 recognized as ordinary income) multiplied by 10 shares).

Example (2): Assume the same facts as the previous example, except that B dies in 2023, when the fair market value of X Corp. stock is $95 per share. B's estate recognizes $100 of ordinary income in the year of her death (the lesser of (1) the excess of the $100 fair market value of the stock on the date of exercise over the $85 exercise price multiplied by 10 shares, or (2) the excess of the $95 fair market value of the stock on the date of death over the $85 exercise price multiplied by 10 shares).

Example (3): On January 1, 2018, all employees of X Corp. were granted rights to purchase a maximum of 250 shares of X Corp. stock at the lower of 85% of the stock's fair market value as of the date of grant or 85% of the stock's fair market value on the date of exercise. On January 1, 2018, the fair market value of X Corp. stock was $100. B exercised 10 purchase rights on December 31, 2018, when the fair market value was $150 a share, at $85 per share. B sells the X Corp. stock for $140 per share on December 31, 2023. In 2023, B recognizes $150 in ordinary income (the lesser of (1) the excess of the $100 fair market value of the stock on the date of grant of the purchase rights over the $85 discounted purchase price at that time multiplied by 10 shares, and (2) the excess of the amount realized on the disposition ($140) over the exercise price ($85) multiplied by 10 shares). The amount of capital gain on the sale of the stock is $400 ($140 sales price minus the adjusted basis of the stock ($85 purchase price plus $15 ordinary income) multiplied by 10 shares).

Example (4): Assume the same facts as the previous example, except that on December 31, 2018, the fair market value of X Corp. stock was $60. B exercised 10 purchase rights on December 31, 2018, at $51 (85% of $60) per share. B holds the X Corp. stock until December 31, 2023, and sells it for $140 per share. In 2023, B recognizes $150 in ordinary income (the lesser of (1) the excess of the $100 fair market value of the stock on the date of grant of the purchase rights over the $85 discounted purchase price at that time — not the actual exercise price paid by B — multiplied by 10 shares, and (2) the excess of the amount realized on the disposition ($140) over the exercise price ($51) multiplied by 10 shares).[444] The amount of capital gain on the sale of the stock is $740 ($140 sales price minus the adjusted basis of the stock of $66 ($51 purchase price plus $15 ordinary income) multiplied by 10 shares).

Example (5): On April 1, 2021, all employees of X Corp. were granted rights to purchase a maximum of 250 shares of X Corp. stock at the lower of 85% of the stock's fair market value as of the date of grant or 85% of the stock's fair market value on exercise. On April 1, 2021, the fair market value of X Corp. stock was $100. B exercised 10 purchase rights on September 30, 2021, when the fair market value of X Corp. stock was $60, at $51 per share. B held the stock until April 1, 2023, and sold it for $120. In 2023, B recognized $150 in ordinary income. The amount of capital gain was $540 ($1,200 sales price minus the sum of the $510 purchase price and $150 in ordinary income). All of the capital gain was long-term.[445]

b. Disqualifying Disposition

If the employee sells or otherwise disposes of stock before the expiration of the statutory holding period, i.e., a disqualifying disposition, then in the year of the disqualifying disposition, the employee is required to recognize ordinary income equal to the excess of the fair market value of the stock on the date of exercise of the purchase right over the exercise price.[446] Any additional gain or loss recognized on the disposition of the stock will be short- or long-term capital gain or loss, depending on the length of time the employee holds the stock after exercise of the purchase right.

[441] As discussed above with respect to ISOs, a corporation qualifies as a parent or subsidiary if it satisfies the tests in §424(e) or §424(f), which require ownership of stock representing 50% or more of the combined voting power of all classes of stock. A parent need not be the direct owner of a corporation, and a subsidiary need not be the direct subsidiary of a corporation, as long as they are connected to the corporation by an unbroken chain of corporations, each of which owns 50% of the combined voting power in all classes of stock in one of the others in the chain.

[442] §423(a); Reg. §1.421-1(h).

[443] §423(a); Reg. §1.421-1(h). *See* II.G.4., above.

[444] The exercise price in the second part of the test is the actual exercise price paid by the optionee, not the exercise price on the date of grant. *See* Reg. §1.423-2(k)(3) *Ex.* 3.

[445] Compare this result with the *Example* in III.C.2.b., below. Perhaps, the employee would have had a more favorable tax result had he sold the stock in a disqualifying disposition.

[446] Reg. §1.421-2(b)(1).

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Example: On April 1, 2022, all employees of X Corp. were granted rights to purchase X Corp. stock at the lower of 85% of the stock's fair market value as of the date of grant or 85% of the stock's fair market value on the date of exercise. On April 1, 2022, the fair market value of X Corp. stock was $100. On September 30, 2022, when the fair market value of X Corp. stock is $60, B exercises 10 purchase rights at $51 per share. B holds the stock until March 30, 2024, and sells it for $120. In 2024, B recognizes $90 in ordinary income in a disqualifying disposition. The amount of capital gain is $600 ($1,200 sales price minus sum of adjusted basis of $510 purchase price plus $90 ordinary income). All of the capital gain is long-term.[447]

3. Exercise or Disposition After Death of Employee

a. Exercise After Death of Employee

When an employee dies after the grant of a purchase right but before its exercise, the employee's estate or beneficiary may exercise the purchase right if the §423 plan or offering so permits. If the employee satisfied the employment requirements, the disposition of the stock receives the same tax benefits as a qualifying disposition discussed above, even if the holding periods are not satisfied and even if the stock is sold more than three months after the employee's death.[448] For purposes of this rule, the employee satisfies the employment requirements if, at all times beginning on the date of grant and ending on the day that is three months before the date of the employee's death, the employee was employed by:

- the employer whose stock is subject to the purchase right;
- an employer substituting or assuming the purchase right by reason of a corporate transaction that satisfies the requirements of §424(a); or
- a parent or subsidiary of a corporation described above.[449]

The rules for determining whether an employee satisfies the employment requirements, including the rules for determining whether a substitution or assumption by reason of a corporate transaction satisfies §424(a), are the same as the rules for ISOs.[450]

b. Exercise Before Death of Employee; Disposition After Death

If the employee dies after exercising a purchase right under a §423 plan, the transfer of stock to the employee's estate or beneficiary is not considered a disqualifying disposition.[451] At the employee's death, ordinary income is recognized in an amount equal to the lesser of: (1) the excess of the fair market of the stock on the date of grant of the purchase right over the exercise price on the date of grant and (2) the excess of the fair market value of the stock on the date of death over the amount paid for the stock.[452] The compensation income is included in income in the taxable year of the employee closing with the employee's death.[453]

Although the disposition of the stock triggers ordinary income, the amount of ordinary income that is so triggered does not increase the basis of the stock.[454] The amount included in the gross income of the estate or beneficiary of a deceased employee is allowed as an estate tax deduction as if it were an item of income in respect of a decedent within the meaning of §691.[455] Any transfer of the stock by the estate is considered a disposition of the stock.[456]

Any additional gain or loss recognized on the subsequent disposition of the stock by the estate or beneficiary will be a capital gain or loss.

Practice Insight: Practitioners should consult an estate and gift tax attorney when dealing with the death (or pending death) of the holder of a purchase right.

D. Impact on Employer

1. Employer's Tax Deduction

An employer may not deduct any amounts with respect to the grant or exercise of a purchase right issued pursuant to a §423 plan, or the subsequent sale of the stock acquired through exercise of the purchase right, unless there is a disqualifying disposition of the stock.[457] If an employee acquires stock through the exercise of a purchase right under a §423 plan and then disposes of the stock in a disqualifying disposition (e.g., by failing to meet the §423(a)(1) holding period requirement), the employer is entitled to a deduction equal to the amount the employee must include in income.[458] The employer may take

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[447] Compare this result with *Example (5)* in III.C.2.a., above. The employee has less ordinary income and thus a more favorable tax result because he disposed of his shares in a disqualifying disposition (the disposition is disqualifying distribution because it occurred less than two years from the grant date). *See* Reg. §1.421-2(b)(1) (referencing Reg. §1.423-1(a)).

[448] §421(c); Reg. §1.421-2(c).

[449] §423(a); Reg. §1.421-1(h).

[450] §423(a) (cross-referencing §421(a)); Reg. §1.421-1(h). *See* II.G.4., above.

[451] §424(c)(1)(A). If, during the employee's lifetime, the employee exercises an option granted under a §423 plan, but the employee dies before the stock is transferred to the employee pursuant to the exercise of the option, then for §421 and §423, on the employee's death, the stock is deemed to be transferred immediately to the employee, and immediately thereafter, the employee is deemed to have transferred the stock to the employee's executor, administrator, trustee, beneficiary by operation of law, heir, or legatee, as applicable. Reg. §1.423-2(k)(1)(iv).

[452] §423(c).

[453] Reg. §1.423-2(k).

[454] §421(c)(3); Reg. §1.423-2(k)(2), as amended by T.D. 9811, 82 Fed. Reg. 6235, 6238 (2017) (basis upon death of employee would be determined under §1014 or under §1022, if applicable), effective January 19, 2017. With respect to any determinations under §1014(a), the basis of property acquired by a beneficiary must be consistent with the basis reported for estate tax purposes. §1014(f), added by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, §2004(a), effective for property with respect to which an estate tax return is filed after July 31, 2015. *See also* §6035 (estate executors must furnish statement to IRS and property beneficiary stating property value), added by Pub. L. No. 114-41, §2004(b).

[455] §421(c)(2).

[456] §421(c)(1)(B).

[457] §421(a)(2); Reg. §1.421-2(a)(1)(ii).

[458] §421(b); Reg. §1.421-2(b). See the discussion in II.D. regarding the amendments made by the TCJA (Pub. L. No. 115-97) to §162(m) and the potential effect of those amendments on a publicly held employer's ability to take a deduction in the event of a disqualifying disposition of an ISO by a covered employee. The same issues would arise in connection with a disqualifying disposition of a grant pursuant to an ESPP by a covered employee of a publicly

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this deduction on its return for the taxable year in which the disqualifying disposition occurs.[459]

Effective January 1, 2023, the Inflation Reduction Act imposes a 1% excise tax on the fair market value of stock of a "covered corporation" that is repurchased by the corporation.[460] A "covered corporation" is any domestic corporation with stock traded on an established securities market.[461] In determining the amount of the excise tax, the fair market value of stock repurchased by the corporation during a year is reduced by the fair market value of stock issued by the corporation during the year, including stock issued or provided to employees, whether through exercise of an option or otherwise.[462]

Note: Accordingly, if a covered corporation repurchases stock during a year, the exercise of purchase rights by employees during that year will generally reduce the amount of the excise tax owed with respect to the repurchases.

2. Withholding

As discussed in II.D.3., above, with respect to ISOs, certain income resulting from ISOs and §423 plans is excluded from the definition of wages for specified income and payroll tax purposes and associated withholding obligations, but this exclusion does not relieve individual taxpayers from the obligation to report on their tax returns the taxable income relating to the disposition of stock acquired pursuant to the exercise of a purchase right, which may have to be included in estimated tax. The IRS generally requires that the income of an employee from a qualifying or disqualifying disposition of stock acquired under an employee stock purchase plan be reported as "other compensation" in Box 1 on Form W-2.

3. Reporting and Disclosure

a. Background

Section 6039 imposes reporting requirements on corporations with respect to the transfer of stock acquired under §423 plans if the exercise price of the purchase right is less than 100% of the value of the stock on date of grant or is not fixed or determinable on the date of the grant.[463] Every corporation that recorded (or has recorded by its transfer agent) the first transfer by an employee or former employee of stock purchased by such employee exercising a purchase right under a §423 plan must (i) file an information return with the IRS and (ii) furnish a copy of such information to the employee who exercised the purchase right.

The return is required only with respect to the first transfer of such shares by the employee who exercised the purchase right, including the first transfer of legal title to a recognized broker or financial institution.[464] The corporation must identify the stock in a manner sufficient to enable the accurate reporting of the transfer of legal title to such shares. This may be accomplished by assigning a special serial number or color to the stock certificates issued pursuant to the exercise of the options.[465]

If, instead of establishing a brokerage arrangement, an employer either issues a stock certificate directly to an employee who purchases stock pursuant to a §423 plan, or registers the shares in the employee's name on the employer's record books and the employer or its transfer agent holds the shares for the employee in book-entry form, the issuance of the stock certificate or the registration of the stock ownership on the record books is not considered the first transfer of legal title of the stock acquired by the employee. Accordingly, the employer is not required to file a return and furnish an information statement to the employee with respect to such a transfer. Instead, the employer must file a return and furnish an information statement to the employee with respect to the first transfer of the legal title of the stock acquired by the employee (for example, when the employee sells the stock or transfers the stock to a brokerage account established on behalf of the employee). Consequently, for reporting purposes, if a stock certificate is issued or the ownership of the shares is registered on the employer's record books following the exercise of an option, the exercise of the option and the first transfer of legal title occur on different dates, unless the shares are immediately sold or otherwise transferred.[466]

The return requirement under §6039(a)(2) does not apply to the first transfer of legal title of a share of stock by an employee who is a nonresident alien (as defined in §7701(b)) and to whom the corporation is not required to provide a Form W-2 for any calendar year within the time period beginning with the first day of the calendar year in which the option was granted to the employee and ending on the last day of the calendar year in which the employee first transferred legal title to shares acquired under the option.[467]

b. IRS Information Return

A corporation that recorded (or has recorded by its transfer agent) the first transfer by an employee or former employee of

held corporation. For a detailed discussion of this topic, see 390 T.M., *Reasonable Compensation.*

[459] Reg. §1.421-2(b); *See also* §83(h); Reg. §1.83-6(a). For a discussion of the compensation deduction rules in Reg. §1.83-6(a), see II.D.4.e., above.

[460] §4501, as added by the Inflation Reduction Act, Pub. L. No. 117-169, §10201, effective for taxable years beginning after December 31, 2022. For further discussion of this excise tax, including the reporting and payment rules, see 767 T.M., *Redemptions.*

[461] §4501(b), as added by Pub. L. No. 117-169. Certain acquisitions of stock of the covered corporation by a "specified affiliate" of the covered corporation are treated as repurchases by the covered corporation.

[462] §4501(c)(3), as added by Pub. L. No. 117-169.

[463] §6039(a)(2), §6039(b); Reg. §1.6039-1(b), §1.6039-2(b).

[464] §6039(c)(2); Reg. §1.6039-1(b)(3). If, under an agreement with a recognized broker or financial institution, shares acquired upon exercise of the option will be immediately deposited into a brokerage account established on behalf of the transferor, the deposit of shares by the transferor into the brokerage account following the exercise of the option is considered the first transfer of legal title of the shares acquired by the transferor, and the corporation is only required to file a return relating to that transfer of legal title.

[465] Reg. §1.6039-1(b)(4).

[466] Preamble to T.D. 9470, 74 Fed. Reg. 59,087, 59,088–89 (Nov. 17, 2009). Those employers wanting to satisfy this reporting obligation for all employees at the same time should consider entering into an agreement with a recognized broker or financial institution under which shares acquired upon exercise of the option will be immediately deposited into a brokerage account established on behalf of the employee.

[467] Reg. §1.6039-1(e)(2). For this purpose, a corporation is defined in §7701(a) and includes, but is not limited to, the corporation issuing the stock, a related corporation of the corporation, any agent of the corporation, any party distributing shares of stock or other payments in connection with the plan (for example, a brokerage firm), and any party in control of the payment of remuneration for employment to the employee. Reg. §1.6039-1(e)(3).

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stock purchased by such employee exercising a purchase right under a §423 plan is required to file a Form 3922, *Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c),* with the IRS for that calendar year on or before February 28 of the year following the year of first transfer of the stock acquired through the employee stock purchase plan (or March 31 if filing electronically).[468] An automatic 30-day filing extension is available by filing Form 8809, and an additional 30-day extension may be requested.[469]

Corporations may satisfy the information return requirement by submitting a substitute Form 3922 in accordance with the guidelines set forth in IRS Pub. 1179 (or its designated successor).[470] If an employer fails to file the IRS information return, penalties may be assessed under §6721.[471]

Information returns required to be filed on or after January 1, 2024 must be filed electronically by any person that is required to file 10 or more information returns in that calendar year.[472] All information returns listed in Reg. §301.6011-2(b)(1) and §301.6011-2(b)(2) including Forms 3921, 3922, and W-2, are aggregated in determining whether a person is required to file 10 or more information returns in a calendar year.[473] In calendar years beginning before 2024, any person that was required to file 250 or more Forms 3922 during the calendar year had to file those returns electronically.

Persons may ask the IRS to waive the electronic filing by filing Form 8508, *Application for a Waiver from Electronic Filing of Information Returns.*[474]

Beginning September 26, 2021, requests for authorization to file Form 3922 electronically through the Filing Information Returns Electronically (FIRE) System are made using the new online *Information Returns (IR) Application for Transmitter Control Code (TCC)*, available on the Filing Information Returns Electronically (FIRE) page on IRS.gov. Prior to that, persons submitted Form 4419, *Application for Filing Information Returns Electronically (FIRE)*, to request authorization. In September 2021, Form 4419 was renamed to *Revise Existing Transmitter Control Code (TCC) for Filing Information Returns Electronically (FIRE)* and is now only used to revise the legal name or other information associated with an active TCC obtained before September 26, 2021.

c. Employee Information Statement

A corporation that is required to file a Form 3922 must also file an information statement with each employee named in that return.[475] Employers can meet this requirement by sending Copy B of the Form 3922 to the employee.[476]

The statement must be furnished on or before January 31 of the year following the year of first transfer of the stock acquired through the employee stock purchase plan.[477] An extension of time to furnish the information statement may be granted by the IRS for an additional 30 days if good cause is shown.[478] If the employer fails to furnish any such statement, penalties may be assessed under §6722.[479]

Employee information statements must be delivered in person or mailed to the recipient's last known address. They may be delivered electronically if the recipient properly consents to such a means of delivery.[480]

d. ERISA

A §423 plan is not subject to the Employee Retirement Income Security Act of 1974 (ERISA).[481] Therefore, it is not subject to ERISA's reporting requirements, and a summary plan description need not be distributed to participants or filed with the Department of Labor.[482]

E. Modification, Extension, or Renewal of Purchase Rights

As with an ISO, the modification, extension or renewal of a purchase right under a §423 plan will be considered the grant of a new purchase right.[483] Unlike an ISO, however, a purchase

[468] §6039(a); Reg. §1.6039-1(b)(2), §1.6039-1(c); Instructions to Forms 3921 and 3922; Part C of the IRS General Instructions for Certain Information Returns.

[469] Reg. §1.6081-8(a), as amended by T.D. 9838, 83 Fed. Reg. 38,023 (Aug. 3, 2018), applying to requests for extensions of time to file information returns required to be filed after December 31, 2018; former Reg. §1.6081-8T(a), applying to extensions of time to file information returns due after December 31, 2016, and required to be filed before January 1, 2019.

[470] Preamble to T.D. 9470, 74 Fed. Reg. 59,087, 59,090 (Nov. 17, 2009).

[471] Reg. §1.6039-1(d).

[472] Reg.§301.6011-2(c)(1) and §301.6011-2(g), as amended by T.D 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023).

[473] Reg. §301.6011-2(c)(4), as amended by T.D. 9972, 88 Fed. Reg. 11,754 (Feb. 23, 2023). Form 3922 was added to Reg. §301.6011-2(b)(1) in T.D. 9972.

[474] Form 8508 lists permissible justifications for waiver, including undue financial hardship. However, Treasury and IRS have stated that based on the sophistication of filers of Forms 3922, and the accessibility and availability of electronic filing, these filers are unlikely to incur unreasonable costs to electronically file these returns. Preamble to REG-102951-16, 86 Fed. Reg. 39,910, 39,913 (July 23, 2021) (proposed rules finalized in T.D. 9972).

[475] §6039(b).

[476] Part M of the IRS General Instructions for Certain Information Returns. Corporations may also satisfy the employee information statement requirement by submitting substitute Forms 3922 in accordance with guidelines set forth in IRS Pub. 1179 (or its designated successor). For example, a corporation could satisfy the IRS return requirement by submitting Form 3922 to the IRS, and satisfy the employee information statement requirement by delivering substitute Forms 3922 to the appropriate recipients. Part M of the IRS General Instructions for Certain Information Returns; preamble to T.D. 9470, 74 Fed. Reg. 59,087, 59,090 (Nov. 17, 2009).

[477] §6039(b); Reg. §1.6039-2(c)(1). Part M of the IRS General Instructions for Certain Information Returns.

[478] Reg. §1.6039-2(c)(2) (extensions of time may be granted in accordance with instructions to Form 3922); Part M of the IRS General Instructions for Certain Information Returns.

[479] Reg. §1.6039-2(d).

[480] Instructions to Forms 3921 and 3922. Part M of the IRS General Instructions for Certain Information Returns. Consent to electronic delivery must be obtained by following the requirements under Reg. §31.6051-1(j)(2)(i), which requires, among other things, that an individual affirmatively consents in a manner that demonstrates that the individual can access the same electronic format in which the §6039 notices will be furnished.

[481] Pub. L. No. 93-406, 88 Stat. 829 (1974), as codified at 29 U.S.C. §1001–§1461.

[482] *See* DOL Adv. Op. 90-17A (June 25, 1990), DOL Adv. Op. 77-23 (Feb 14, 1977).

[483] §424(h)(1); Reg. §1.424-1(e)(2). A statutory option may cease to be a statutory option as a result of a modification, extension or renewal. Reg. §1.424-1(e)(5). Further, although the grant of a purchase right under a §423 plan, including the grant of a purchase right with an exercise price discounted in accordance with §423(b)(6) and the accompanying regulations, does not constitute a deferral of compensation for purposes of §409A, the exclusion for statutory stock options does not apply to a modification, extension or renewal of a statutory stock option that is treated as the grant of a new option that is not

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right under a §423 plan that is modified, renewed or extended must have an exercise price of at least 85% of the highest of the fair market value of the stock subject to the option at the initial grant, the modification date, or the date of any previous modification.[484]

In general, the hallmarks of a modification, extension or renewal of a purchase right under a §423 plan are the same as with an ISO.[485] A modification is any change in the terms of a purchase right outstanding under a §423 plan, whether through the amendment of the outstanding purchase right or of the plan, that provides additional benefits to participants.[486] In situations in which an amendment was made (with shareholder approval) to a §423 plan during an offering period to increase the number of shares of stock available for purchase during that offering in order to meet the demand of participants and thus facilitate participants' purchases of shares for which they had already enrolled, two PLRs have concluded that the amendment was not a modification of outstanding options or a grant of new options.[487] Note, however, that such an amendment during an offering to increase the number of shares available for purchase during that offering may have adverse accounting consequences.[488]

F. Mergers and Acquisitions

As with ISOs, mergers, acquisitions and similar transactions present challenges and planning opportunities to a §423 plan that should be addressed in the initial drafting of the plan. Also as with ISOs, the substitution or assumption of outstanding purchase rights under a §423 plan by an "eligible corporation" by reason of a "corporate transaction" is not a modification, renewal or extension of any such purchase right under §424(h) as long as the aggregate bargain purchase element and ratio tests of §424(a) are satisfied.[489] Accordingly, a §423 plan can be drafted to provide that upon a merger or similar transaction, the acquiring corporation may assume purchase rights outstanding under the plan or may replace the rights with comparable rights under its own §423 plan. In order to facilitate a smooth transition following an acquisition and to provide employees holding purchase rights under the §423 plan with the right to exercise their purchase rights to the extent of their accrual as of the closing of the acquisition transaction, a §423 plan may provide that in the event that the acquiring corporation does not assume outstanding rights or substitute comparable rights therefore, the employees' rights that have accrued as of the closing date of the acquisition transaction will be automatically exercised.

An additional issue arises when an acquiring corporation that maintains a §423 plan wants to permit the employees of a newly acquired target corporation (the "target employees") to begin participating in its existing §423 plan without regard to the usual entry or offering dates under the §423 plan. As discussed in III.B.3., §423(b)(5) requires that all employees granted rights under a §423 plan have the same rights and privileges with respect to their participation in the §423 plan. The §423 regulations, however, provide that an employee who is barred from being granted an option solely by reason of the employee's failing to meet a minimum service requirements may be granted rights under the offering when they meet the service requirements without violating the equal rights and privileges requirement of §423(b)(5).[490] An example in the regulations further provides that an employer may make separate offerings under a §423 plan to separate subsidiaries participating in the plan, and the plan and offerings will not violate the equal rights and privileges requirement even if the terms of one offering are more favorable than those of the other offering.[491] Private letter rulings have concluded that an acquiring corporation may permit employees of the acquired corporation to begin participating in an existing §423 plan immediately following the acquisition of the target corporation where only the target employees were permitted to commence participation in the §423 plan at that time.[492]

G. Securities Law and Stock Exchange Considerations

The discussion of federal and state securities law and stock exchange requirements applicable to ISOs in II.I., above, is also applicable to §423 plans. In addition, the SEC has taken the position that an election made by an employee to authorize payroll deductions under a §423 plan is an "investment decision" for purposes of the Securities Act of 1933 ("1933 Act").[493] Accordingly, such an election will violate the 1933 Act's prohibition on the offer or sale of unregistered securities unless the election is made following the filing of a registration statement covering the §423 plan or pursuant to an available exemption. In order to avoid liability under §5 of the 1933 Act, employers completing an initial public offering should wait to enroll employees in the §423 plan until a Form S-8 registration statement has been filed with the SEC covering the shares of common stock reserved for issuance under the §423 plan. In addition, employers with existing §423 plans should carefully monitor the share reserves under their plans to make certain that all shares available for issuance are registered on a Form S-8 reg-

a statutory stock option. In that case, the option is treated as if it had been a nonstatutory stock option from the date of the original grant, and if such modification, extension or renewal of the option would have been treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant under Reg. §1.409A-1(b)(5)(v), the modification, extension or renewal is treated as the grant of a new option or as causing the option to have had a deferral feature from the date of grant. Reg. §1.409A-1(b)(5)(ii). For a discussion of §409A, see 385 T.M., *Deferred Compensation Arrangements.*

[484] §424(h)(2); Reg. §1.424-1(e)(3).

[485] Reg. §1.424-1(e)(4).

[486] Reg. §1.424-1(e)(4). *See* PLR 200418020 (proposed amendments to employee stock purchase plan that did not provide additional benefits to plan participants were not modifications under §424(h)(3) and thus did not require stockholder approval under §423(b)(2) because no new plan was created).

[487] PLR 9314035, PLR 9222046.

[488] *See* FASB ASC ¶718-20-35-2A, ¶718-20-35-3.

[489] Reg. §1.424-1(a). See discussion above in II.G.4.

[490] Reg. §1.423-2(f)(6), §1.423-2(f)(7) *Ex.* 3.

[491] Reg. §1.423-2(f)(7) *Ex.* 5.

[492] *See* PLR 9245020 (employees of newly acquired subsidiary could participate in special purchase period). *See also* PLR 200244006, in which the IRS ruled that in calculating the $25,000 limit under §423(b)(8), both the fair market value of the employer's stock (determined on the grant date of the purchase right) purchased under such a special offering and the fair market value of the target corporation's stock (determined on the grant date of the purchase right) purchased under the target corporation's §423 plan just before the effective time of the transaction must be taken into account.

[493] SEC No-Action Letter issued to American Bar Assn. (avail. July 25, 2000).

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istration statement at the time that employee payroll deductions are made for the purpose of purchasing those shares.

H. International Issues

Section 423 generally requires that all eligible employees (except for those specifically permitted to be excluded), including non-U.S. employees, of a corporation that maintains a §423 plan be allowed to participate in the plan and have the same rights and privileges under a §423 plan.[494] In some cases, applicable foreign law may make it impossible for an employer to include foreign employees in its §423 plan. For example, if offerings of U.S. securities in a particular foreign jurisdiction are effectively prohibited, employees in that jurisdiction cannot be permitted to participate. In other cases, the provisions of foreign law may make it impossible for an employer to offer the same rights and privileges to some foreign employees as it does to other employees in the plan.

There are several methods available to deal with these issues. Because the requirement to cover all employees applies on a corporation-by-corporation basis, the employer may exclude employees of foreign subsidiaries.[495] Issues can still arise, however, with respect to employees of foreign branches of a U.S. multinational corporation that maintains a §423 plan.[496]

The regulations provide rules to deal with situations in which foreign laws makes it impossible to comply with those laws and §423 or where compliance with foreign laws precludes offering the employees subject to those laws the same rights and privileges under a §423 plan as other employees. First, a §423 plan or offering may exclude employees who are citizens or residents of a foreign jurisdiction where local law prohibits their participation or compliance with the laws of such foreign jurisdiction would violate §423.[497]

Also, a plan or offering does not fail to satisfy the requirement to offer the same rights and privileges to all employees if, to comply with the laws of a foreign jurisdiction, the terms of a purchase right granted to foreign employees are less favorable than the terms of purchase rights granted to U.S. employees.[498] An employer might also consider implementing separate offerings under its §423 plan for its non-U.S. employees who are employed by foreign subsidiaries as an alternative to including those non-U.S. employees directly in its §423 plan. Such separate offerings would be independently evaluated for compliance with the requirements of §423 (e.g., equal rights and privileges).[499] This may be particularly helpful when local law does not prohibit offering the same rights and privileges as those offered to U.S. employees but provides tax advantages to the employees or employer if different terms are offered.

Some employers historically had adopted separate §423 plans for domestic and foreign employees, with a single share reserve used by both plans. A stock purchase plan does not satisfy §423, however, if it does not have a separately stated share reserve but instead shares a reserve with another stock purchase plan.[500] However, the result desired by having two plans with a common share reserve can be achieved in a permissible manner if there is a single stock purchase plan that has two separate offerings.

I. Accounting Treatment of Stock Purchase Plans

Under accounting rules issued by the Financial Accounting Standards Board (FASB),[501] the fair value of the rights granted pursuant to a §423 plan generally must be calculated and recorded as a compensation cost unless the discount is no greater than 5% and the plan does not contain a "look-back feature."[502]

The compensation cost depends on the "type" of plan. FASB rules describe nine types of employee stock purchase plans, each of which complies with §423.[503] The differences among the plan "types" include, for example:

- whether the plan contains a "look-back" pricing feature;
- whether the maximum number of shares that may be purchased by an employee is established at the date of grant based on the stock price at that date and the employees' elected withholdings;
- whether the plan contains multiple purchase dates;
- whether the plan contains a "reset" feature (under which if the stock price is lower at the end of any six-month purchase period than at the original grant date, then the purchase price resets to a percentage of the fair market value at the beginning of the next purchase period or the exercise date);
- whether the plan contains a "rollover" feature (under which if the stock price is lower at the end of any six-month purchase period than at the original grant date, then the plan is immediately cancelled after that purchase date, and a new two-year plan is established using the then-current stock price);
- whether participants may increase or decrease participation rates during an ongoing offering period; and

[494] §423(b)(5); Reg. §1.423-2(a)(3)(iii), §1.423-2(f).

[495] Reg. §1.423-2(e)(3); PLR 8225050.

[496] For additional discussion regarding §423 and multinational corporations, see 322 T.M., *Global Share Plans: Issues for Multinational Employers.*

[497] *See* Reg. §1.423-2(e)(3); Rev. Rul. 71-39; PLR 7849047.

[498] Reg. §1.423-2(f)(4).

[499] Reg. §1.423-2(f)(7) *Ex.* 5.

[500] Reg. §1.423-2(c)(3).

[501] Note that, effective for interim and annual periods ending after September 15, 2009, FASB codified all of its authoritative nongovernmental U.S. generally accepted accounting principles (U.S. GAAP) into a single source in its Accounting Standards Codification ("FASB ASC"), *available at* http://asc.fasb.org.

[502] Statement of Financial Accounting Standards No. 123, revised in 2004 as FAS 123(R), codified at FASB ASC ¶718-10-55. Specifically, a plan is treated as being noncompensatory if the following conditions are met: (1) either (a) the plan has terms that are no more favorable than those that are available to all holders of the same class of stock, or (b) any purchase discount does not exceed the per-share issuance costs that would be incurred through a public offering of stock (a discount of 5% or less is a safe harbor) and, if greater than 5%, is reassessed at least annually; (2) substantially all eligible employees may participate in the plan on an equitable basis; and (3) the plan incorporates no option features other than (a) employees are permitted a short period of time (not exceeding 31 days) after the purchase price has been fixed to enroll in the plan, and (b) the purchase price is based solely on the market prices of the shares at the date of purchase (no look-back feature), and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid. FAS 123(R), codified at FASB ASC ¶718-50-25-1, ¶718-50-25-2.

[503] FASB Technical Bulletin 97-1 (FTB 97-1), codified at FASB ASC ¶718-50-55-2.

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• whether employees are permitted to remit "catch-up" amounts of cash.

The compensation cost of a §423 plan contains three components. First, the discount is treated as a compensation expense. Next, the "look-back" pricing feature is treated as a "call option" with a value determined based upon an accepted option pricing model. Third, if the offering does not limit the number of shares that the employee is permitted to purchase (for example, if the purchase date stock price is lower than the date of grant stock price), the plan is treated as guaranteeing that the employee can always receive the value associated with the discount being offered. Without such a limit, the employee is treated as having a "put option" resulting in an additional compensation cost equal to the guaranteed return to which the employee is entitled.[504]

"Reset" and "rollover" features and increases in participation rates (other than through increases in compensation) are treated as modifications under FAS 123(R), thus resulting in the employer's recognition of an additional compensation cost in an amount equal to the excess of the fair value of the modified award over the fair value of the original award immediately before the modification.[505]

Practice Insight: Because the FASB rules have required that employers recognize the compensation cost associated with the offering of purchase rights under a §423 plan, many employers have amended their plans to reduce or eliminate the compensation cost. Such amendments include, for example, shortening the "look-back" period or eliminating the "look-back" pricing feature; shortening the offering period; reducing the purchase price discount; reducing the percentage of pay that a participant may use to purchase shares; reducing the number of shares a participant may purchase on any purchase date; and adopting a "safe harbor" plan (with a maximum 5% discount on the purchase date and no look-back feature).

For further discussion of accounting issues, see II.J., above, and 341 T.M., *Accounting for Share-Based Compensation.*

[504] *See* FTB 97-1, ¶7, codified at FASB ASC ¶718-50-55-5. For example, assume that an offering provides a purchase price of 85% of the fair market value of the stock on the lower of the offering date or the purchase date, but does not provide a limit on the number of shares which may be purchased. In this case, the employee is guaranteed a 15% return, and the value of a 15% put option will be included in the compensation cost.

[505] *See* FTB 97-1, ¶16–¶18, codified at FASB ASC ¶718-50-55-28 through FASB ASC ¶718-50-55-31.

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