Early Exercise Stock Options

A Lexis Practice Advisor® Practice Note by
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This practice note discusses Early Exercise Stock Options, which are stock options that the holder can exercise before they vest. Depending on the type of stock option issued and the holder's financial and tax situation, the holder may be able to obtain more favorable tax treatment through an early exercise. This note discusses the advantages and disadvantages of Early Exercise Stock Options and compares them to certain other equity-based compensation awards.

This practice note is organized around the following topics:

- Key Characteristics of Stock Options
- Types and Tax Treatment of Typical Stock Options
- Mechanics of Early Exercise Stock Options
- Advantages of Early Exercise Stock Options
- Disadvantages of Early Exercise Stock Options
- Comparison to Full Value Equity Awards

For more information on stock options and equity-based compensation awards generally, see Equity and Incentive Compensation Arrangements for Startup Companies and Equity Compensation Types and Tax Treatment.

KEY CHARACTERISTICS OF STOCK OPTIONS

A stock option represents a right to buy a fixed number of shares of a company's common stock at a fixed exercise price (typically the fair market value of the stock on the date of grant). Companies grant stock options and other types of equity awards to allow employees to share in the growth of the company's value and to incentivize employees to remain with the company.

Following is a discussion of the key terms and the accounting impact of stock options.

Key Terms

A typical option contains the following key terms:

- **Term**. An option usually has a term of 10 years. Although, since the advent of option expensing, some companies have moved to a shorter period (usually seven years), to limit the amount of expense recognized for financial accounting purposes (as discussed under "Financial Accounting Impact" below).

- **Vesting schedule**. Stock options typically vest over a set time period (e.g., over four years, with 25% of the shares vesting after one year and the remaining shares vesting in equal monthly or quarterly increments over the following three years, subject to the employee's continued service). Options may contain additional performance-based vesting conditions, but these are less common. The option is usually only exercisable once vested (Early Exercise Stock Options are an exception to this rule).
- **Post-termination exercise period**. If the employee leaves the company prior to the expiration of the exercise period, he or she will usually only have a limited time following termination (typically three months, but it may be a longer period, such as 12 months, if the termination is due to death or disability) to exercise the option before it expires. The length of these commonly used post-termination exercise periods is derived from the maximum length of time following termination that is permitted for an option to retain its status as an incentive stock option for tax purposes (as described under "Incentive Stock Options" in Types and Tax Treatment of Typical Stock Options, below).

Financial Accounting Impact

Prior to 2006, the grant of stock options to employees generally did not result in the recognition of an expense for financial accounting purposes. Instead, they were treated favorably using an intrinsic value approach, with no compensation expense required for options granted to employees as long as the exercise price was not less than the fair market value of the stock on the grant date. APB Opinion No. 25. The financial accounting treatment of stock options changed in 2006, and corporations are now required to recognize an expense for stock options even if the options are not issued at a discount. ASC Topic 718. The amount of the expense is based on the fair value of the option as of the grant date and the expense is recognized over the vesting period.

The expense is usually based on an option pricing model (such as the Black-Scholes pricing model), which takes into account certain assumptions, including:

- The fair value of the underlying common stock
- The expected term of the option
- The expected volatility of the company's stock price
- Risk-free interest rates
- The expected dividend yield of the company's stock

TYPES AND TAX TREATMENT OF TYPICAL STOCK OPTIONS

For U.S. federal income tax purposes, options are treated as either incentive stock options (ISOs) or nonqualified stock options (NQSOs), as discussed below.

Incentive Stock Options

A company may only grant ISOs to employees (as opposed to consultants and non-employee directors) of the company (or a parent or subsidiary corporation of the company). ISOs must satisfy the following requirements:

- An ISO must be granted pursuant to a written plan which has been approved by the company's stockholders and designates a maximum number of ISOs which may be issued thereunder.
- The term of the plan may not exceed 10 years.

- The term of the ISO may not exceed 10 years (or five years if the employee is a 10% stockholder).
- The ISO must be nontransferable (unless upon the death of the employee).
- The exercise price must be no less than the fair market value of the stock on the grant date (or 110% of fair market value if the employee is a 10% stockholder).
- The total fair market value of all ISO shares held by an individual which first become exercisable during any calendar year (as determined by the fair market value of the stock on the grant date) may not exceed $100,000.
- The individual must exercise the ISO while he or she is an employee of the company (or a parent or subsidiary corporation of the company) or within three months after ceasing to be an employee (or within 12 months if terminated due to disability). There is no post-termination exercise deadline if the termination is due to death.

26 C.F.R. § 1.422-2(a)(2)(i)–(vi).

An employee generally will not recognize any taxable income upon the exercise of an ISO, although the amount by which the fair market value of the shares on the exercise date exceeds the option exercise price (the Exercise Spread) will be a so-called item of adjustment for alternative minimum tax (AMT) purposes. I.R.C. §§ 421(a), 56(b)(3).

If an employee receives shares pursuant to the exercise of an ISO and does not dispose of the shares before the later of (1) two years after the date of grant and (2) one year after the exercise date, then upon the resale of such shares, any amount realized in excess of the exercise price paid for the shares will be treated as long-term capital gains and any loss incurred will be long-term capital loss. 26 C.F.R. § 1.421-2(a)(1)(i); 26 C.F.R. § 1.422-1(a)(1)(i)(A). In this case, the company will not be entitled to a deduction for income tax purposes with respect to the disposition of the shares acquired upon exercise of the ISO. 26 C.F.R. § 1.421-2(a)(1)(ii).

If the employee disposes of ISO shares before the expiration of either holding period described above (a so-called disqualifying disposition), he or she will recognize ordinary income in the year of disposition in an amount equal to the excess (if any) of the fair market value of the shares on the exercise date (or, if less, the amount realized on the disposition of the shares) over the option exercise price paid for the shares. Any further gain or loss realized will be taxed as short-term or long-term capital gain or loss (long-term if the shares were held for more than 12 months), as the case may be. The company will be entitled to a tax deduction equal to the amount of ordinary income recognized upon a disqualifying disposition of the ISO shares. 26 C.F.R. § 1.421-2(b).

For more information on ISOs, see Incentive Stock Option Checklist Considerations.

Nonqualified Stock Options

A company may grant NQSOs to employees, as well as non-employee directors and consultants. Upon the exercise of an NQSO (assuming it is vested, and not an early exercise stock option), the recipient will recognize taxable ordinary income equal to the Exercise Spread. I.R.C. § 83(a). The company is required to withhold taxes based on the ordinary income recognized and entitled to a tax deduction in an amount equal to the amount of such ordinary income. Upon disposition of the shares, the holder will recognize a capital gain or loss equal to the difference between the sales price and the sum of the amount paid for such shares plus any amount recognized as ordinary income upon the NQSO exercise.

For more information on taxation of NQSOs, see Tax Risks of Equity-Based Compensation.

MECHANICS OF EARLY EXERCISE STOCK OPTIONS

Early Exercise Stock Options are options (whether NQSOs or ISOs) that the holder can exercise (and purchase shares) before the option vests. Historically, private technology companies granted Early Exercise Stock Options to potentially lower the recipients' tax rate and to raise cash through the exercise price being paid (as start-ups are traditionally cash-poor). Public companies do not typically grant Early Exercise Stock Options.

If the option holder takes advantage of the early exercise feature, the holder pays the exercise price and acquires unvested shares (i.e., restricted stock) which then vest pursuant to the original vesting schedule. There is typically no acceleration of vesting upon an acquisition (unless the buyer elected not to assume or substitute for the options), although grants to executives sometimes include an acceleration of vesting provision for a termination of employment following a change in control.

In the event an employee leaves prior to the vesting of an early exercised option, the company typically will have a call right to repurchase the unvested shares at the lower of the original cost (i.e., the original exercise price paid) or fair market value of the shares at the time of termination. If an employee leaves a privately held corporation, the company typically would not repurchase the employee's vested shares acquired upon a prior exercise of an option (although it would retain a right of first refusal if the employee attempted to transfer the shares while the company was still privately held). In limited circumstances, the employee may have the right to sell the unvested shares back to the company (at the lower of original cost or fair market value) under certain involuntary forms of termination.

ADVANTAGES OF EARLY EXERCISE STOCK OPTIONS

The following are some advantages of Early Exercise Stock Options.

Minimize the Income Tax Amount

If an employee waited until the option vests in order to exercise, the value of the underlying stock hopefully would have appreciated significantly between the grant date and the exercise date. In contrast, if an employee exercises an option early and acquires unvested restricted shares, the exercise occurs while there is little to no Exercise Spread. In this case, the employee generally would be taxed as the underlying shares vest, based on the value of the stock on the vesting date. However, an employee is allowed to file an election pursuant to I.R.C. § 83(b) (a Section 83(b) Election) with respect to the unvested restricted shares in order to have the amount of ordinary income tax (if the option was an NQSO) or AMT (if the option was an ISO) determined as of the date of exercise (rather than as of the date that the shares will vest following the early exercise date).

No income would be recognized upon exercise if the employee exercises the NQSO before the fair market value of the stock increases (as there would be no Exercise Spread). There also would be no AMT recognized if the employee filed a Section 83(b) Election with respect to unvested shares acquired upon the exercise of an ISO. However, the Section 83(b) Election for an ISO is only effective with respect to AMT. Additionally, if there is a disqualifying disposition of the shares (e.g., a disposition within two years after the ISO grant date) or the employee does not make the Section 83(b) Election, the ordinary income would be measured based on the fair market value of the shares on the vesting date and the capital gains holding period would begin on the vesting date rather than the exercise date, which could result in adverse tax consequences for the employee. See 26 C.F.R. § 1.422-1(b)(3), Example 2.

Start the Capital Gains Holding Period

As described above, the favorable long-term capital gains tax rate applies if the employee holds the shares for more than 12 months. Assuming that the employee timely files a Section 83(b) Election, he or she can start the holding period for capital gains purposes on the early exercise date. 26 C.F.R. § 1.83-4(a). In other words, a recipient is more likely to be able to obtain long-term capital gains treatment on all of his or her option gain if the recipient exercises the option shortly after grant.

For further discussion on making Section 83(b) elections, see Tax Risks of Equity-Based Compensation. For a sample Section 83(b) election, see Section 83(b) Election Form (Restricted Stock).

DISADVANTAGES OF EARLY EXERCISE STOCK OPTIONS

While early exercise of an option provides the employee with a potential tax benefit, there are disadvantages to this approach for the employee as well as the company, as discussed below.

Investment Risk

By exercising early, an employee presumably expects to realize a gain on a subsequent disposition of the shares. However, there is investment risk associated with early exercise, as the employee is committing to pay the exercise price at an early date when the company's price appreciation is not certain and an employee may in fact never realize a gain on the disposition of the shares.

In the past, many companies permitted employees to exercise their stock options early and pay the exercise price with a promissory note. However, in a number of cases, the value of the stock declined, and the employees were not able to realize a gain on the disposition of the shares and they still owed the principal and interest on the promissory note. Furthermore, in instances where the company decided to forgive the promissory notes due to the drop in the company's stock price, this forgiveness of indebtedness by the company resulted in the employees having to recognize cancellation of debt income pursuant to I.R.C. § 108 and to pay tax on such debt forgiveness.

Administrative Burden

Early Exercise Stock Options may also create administrative burdens for the company. The documents evidencing an early exercise stock option are more complicated than a typical option award agreement with a normal exercise provision. The documents will typically include burdensome provisions, such as provisions related to:

- The company's right to repurchase the unvested shares upon termination of employment (as well as escrow instructions to the extent that any certificates evidencing the unvested restricted shares will be held in escrow prior to vesting)
- The Section 83(b) Election, as well as other related documents, which usually include (1) a summary explaining the purposes of the election, (2) the filing requirements (i.e., the 30-day filing deadline), and (3) spousal consent

The company will also need to set up internal procedures to confirm that the Section 83(b) Elections have been timely filed.

Furthermore, if an employee exercises his or her option to acquire unvested shares and terminates employment before the shares vest, the company usually only has a limited period of time following termination (typically 60–90 days) to exercise its repurchase option to buy back the unvested shares. Companies should adopt procedures to ensure that any unvested restricted shares are repurchased in a timely manner following an employee's termination date. In the event that the value of a private company's stock declines after the employee acquires the unvested shares, the repurchase price would be based on the fair market value of the shares rather than the original purchase price, and the company would have the burden of determining the applicable fair market value for the repurchase (either a value to be determined by the board or confirmation that a recent valuation prepared by an independent appraiser may still be used for this purpose).

Additional Stockholders

Early exercise allows the holder to become a stockholder sooner, which allows the employee to vote his or her restricted shares (even though unvested), receive dividends (if any), and receive all communications provided to stockholders. Having more employees as stockholders may cause concerns in the context of a vote of private corporation stockholders (for purposes of I.R.C. § 280G) to approve compensatory payments to executives in connection with an acquisition so that the executives are not subject to an excise tax and the corporation does not lose a tax deduction for such payments. The Section 280G parachute payment rules require that stockholders must receive sufficient details about the payments in connection with such approval, and the company and the executives may not want a broad group of employees to have access to such information because they exercised stock options early and became stockholders of the company.

For more information on the I.R.C. § 280G shareholder approval process, see Section 280G for Private Companies.

$100,000 Annual Limit on ISOs

If a company grants Early Exercise Stock Options on a broad basis, there may be employees who do not intend to take advantage of the early exercise feature. For those employees, having ISOs may be preferable, as the exercise may occur at a later date when the fair market value of the stock is higher than the exercise price (and an ISO may be more favorable to the employee as he or she may be able to exercise an ISO without incurring any additional tax liability due to the exercise). As described above, I.R.C. § 422(d) imposes a $100,000 limit on the ISO shares which may first become exercisable in a calendar year. This limit focuses on whether the option is exercisable regardless of whether the underlying shares are vested, so the entire value of an early exercise ISO will count towards this $100,000 limit in the year of grant and this may result in fewer of the option shares qualifying as ISOs.

For more information on the $100,000 limitation, see Tax Risks of Equity-Based Compensation and Equity and Incentive Compensation Arrangements for Startup Companies.

Fair Labor Standard Act Considerations

Pursuant to the Fair Labor Standards Act of 1938, income from options granted to employees who are eligible to receive overtime pay must not be exercisable for at least six months following the date of grant, and if a company plans to grant Early Exercise Stock Options to a broad group of employees, it should provide for a six-month restriction on exercise for employees who are eligible to receive overtime pay to avoid any income from options being included in the overtime pay calculation. 29 U.S.C. § 207(e)(8). This can be a surprise to some companies who historically use options for only the executives and then broaden the option-eligible pool of employees.

COMPARISON TO FULL VALUE EQUITY AWARDS

Stock options provide a valuable way to provide equity awards to management and employees, but only deliver value if the company's stock price increases above the stock option exercise price. In some cases, employees are left holding underwater stock options (i.e., options with an exercise price which is higher than the value of the company's stock). In order to restore the incentive, the company would need to take additional actions (e.g., by repricing the options or granting new replacement equity awards). Alternatively, companies can also grant so-called full value awards, such as restricted stock or restricted stock units (RSUs) to employees which provide some value even if the stock price decreases after the grant date, as described below.

Restricted Stock

Restricted stock may be granted outright to the employee, who would not be required to pay a purchase price to acquire the shares. The employee becomes the record owner of the shares and if the employee terminates before the shares are vested, the unvested shares are immediately forfeited for zero consideration. For public companies, restricted stock is often awarded to employees in this manner and this type of full value award will provide a benefit to the employee even if the stock price declines.

Shares of restricted stock will be subject to tax in accordance with I.R.C. § 83 in the same manner as unvested restricted shares acquired upon the early exercise of an NQSO. Employees who receive a restricted stock award with no payment required will be unlikely to file a Section 83(b) Election due to the risk of recognizing income on the grant date (in an amount equal to the grant date fair market value of the shares) and ultimately not vesting in the shares. Instead employees will typically choose to recognize the income on the vesting date in accordance with the general principles of I.R.C. § 83(a).

RSUs

Mechanics of RSUs

Unlike a grant of restricted stock, which involves an actual issuance of shares to the employee which are subject to forfeiture (or repurchase at original cost, if a purchase price was paid) prior to vesting, no shares of the company are transferred upon the grant of an RSU. Instead, an RSU is a bookkeeping unit (i.e., a promise to pay or otherwise deliver the full value of a share of common stock in the future) and the RSU is typically settled through the issuance of shares to the employee shortly after it vests. An RSU does not require the employee to pay an exercise price, and RSUs do not provide any direct ownership, voting, or dividend rights until the shares are actually issued in the future after vesting. Accordingly, RSUs will provide some value to the employee even if the price of the underlying stock declines after the grant date.

Additionally, because RSUs are full value awards, the number of RSUs awarded is generally only equal to one-third of the number of shares subject to a comparable award of options, which helps to limit the potential equity dilution from employee equity awards.

Vesting of RSUs

In order to avoid the vesting and settlement of RSUs (and the related taxation) before the company's stock becomes publicly traded, a common practice for private companies which grant RSUs was to have a two-step approach to vesting. First, the employee would need to satisfy a time-based requirement based on continued service with the company (i.e., four-year pro rata quarterly or annual vesting). However, no shares would vest or be issued solely upon the satisfaction of the time-based schedule. The RSU agreement would also typically require that a liquidity event must occur (i.e., an acquisition of the company or an initial public offering) within a specified period following the grant date of the RSU (e.g., seven or eight years) in order for the RSU to vest and settle.

For example, if an employee received an RSU for 100 shares which vests over four years in equal annual increments and the employee terminates after one year of service, the employee would have satisfied the time-based requirement with respect to 25 shares. If a liquidity event occurs within the time period specified in the agreement evidencing the RSU, the employee would be entitled to receive the 25 shares following the liquidity event but would receive nothing if a liquidity event does not occur within such period.

Tax Treatment of RSUs

An employee recognizes ordinary income when an RSU is settled in an amount equal to full fair market value of the shares (or other consideration) issued to settle the RSUs. Additional appreciation will be taxed as capital gains upon the subsequent sale of the shares. Accordingly, unlike an option (with respect to which an employee may choose when to exercise and therefore trigger a potential tax event), an employee generally does not have control over the timing of receipt of shares (and taxation) of an RSU. The company is entitled to a deduction as of the settlement date in an amount has a withholding obligation with respect to the income recognized when the RSU is settled.

For more information on restricted stock and RSUs, see Equity Compensation Types and Tax Treatment and Current Legal Forms with Tax Analysis § 12.04.

RELATED CONTENT

Practice Notes

- Equity Compensation Types and Tax Treatment
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- Equity Compensation Plan Design for Private Companies
- Equity and Incentive Compensation Arrangements for Startup Companies
- Restricted Stock, Stock Options, and Equity Incentive Compensation Plans for Start-Ups

Checklists

- Equity Compensation Tax Treatment Chart
- Incentive Stock Option Checklist

Annotated Forms

- Incentive Stock Option Award
- Nonqualified Stock Option Award (Employee)
- Nonqualified Stock Option Award (Non-employee Director)
- Section 83(b) Election Form (Restricted Stock)

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