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TECH SECTOR GUIDE TO STOCK OPTIONS: COMPLIANCE, TAX, AND STRATEGIC PLANNING CONSIDERATIONS FOR COMPANY LEADERS

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Tech Sector Guide to Stock Options: Compliance, Tax, and Strategic Planning Considerations for Company Leaders

Stock options are a valuable compensation tool in the tech sector because they can help attract talent when cash is limited, ensure incentives are tied to long-term company growth, and retain employees through time-based vesting schedules. However, they are surrounded by many misconceptions, subject to a web of legal requirements, and can create significant tax liabilities for individuals. This guide covers the basics, compares the differences between incentive stock options and nonstatutory stock options, and provides the top considerations to help your tech company ensure all compliance, tax, and strategic planning goals are met.

Stock Option Basics

A stock option is a right to buy company shares at a fixed price in the future if certain conditions are met. Different rules apply to different types of options. This guide focuses on **incentive stock options** (ISOs) and **nonstatutory stock options** (NSOs). We'll discuss each type in more detail below, but here's an overview:

- Both ISOs and NSOs are subject to federal tax and securities laws (as well as additional regulations in some states) and can implicate other workplace laws.

Related People

Lorie Maring

Partner

404.240.4225

Brett P. Owens

Partner

813.769.7512

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- ISOs receive special tax-favored treatment if strict requirements are met.
- NSOs are more flexible but generally less tax advantageous.
- If properly structured, both ISOs and NSOs can be exempt from onerous rules and avoid potential excise taxes under Section 409A of the Internal Revenue Code (IRC).

> Although there are other forms of equity compensation suc restricted stock grants and employee stock purchase plans (ESPPs), as described in IRC Section 423, this guide focuse stock options only.

Key Terms to Know

- **Grant.** The company grants an individual a stock option by entering into an agreement that specifies details such as the grant date, how many shares are subject to the option, the conditions that must be met before an individual may exercise their right to buy such shares, and the "strike price" (more on that below).. Each grant agreement is generally subject to the terms of a broader company stock option plan that provides additional terms and conditions.
- **Strike Price.** The strike price (or "exercise price") is the price at which an individual may exercise their options to purchase the shares. Ideally, the shares will increase in value over time so that the strike price is lower than the fair market value of the shares at the time of exercise. In order to satisfy the ISO rules (covered in detail below) or to qualify for an exemption under Section 409A, the strike price must be equal to or greater than the fair market value of the shares at the time of grant.
- **Vesting.** Stock option rights are often subject to a vesting schedule, which is most commonly time-based but can also be performance-based. Vesting structures can drive retention. A common setup in the tech world is a four-year vesting schedule with a one-year cliff. Some option agreements accelerate vesting upon certain events, such as a change in control of the company or certain performance incentives.
- **Forfeiture.** Usually, *unvested* stock options are subject to forfeiture upon certain events, such as a termination of

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employment for any reason. Some agreements also include forfeiture provisions that apply even if the options are vested, such as forfeitures upon certain for-cause terminations or if options are not exercised within a certain timeframe following the employee's termination.

- **Exercise.** Once an individual's stock option rights are fully vested, the individual may, but is not required to, exercise those rights by buying shares in accordance with their grant agreement. The applicable timeframe for exercising such rights can vary upon certain triggering events, and, for ISOs, certain timeframes are established by law. The tax treatment upon exercise depends on the type of stock option – more on that below. In addition, some option agreements permit options to be **exercised early** before they have vested, which can be advantageous for tax purposes if a **Section 83(b) election** is timely filed. We'll discuss this further in the NSO section below.

- **Disposition (Liquidity Event).** After an individual has exercised their options, they are owners of those shares (usually on a restricted basis), and can sell (or, under certain conditions, may be forced to sell) them subject to the terms of the governing documents. Disposition is always a taxable event, but the tax treatment varies depending on the option type.

Snapshot of Incentive Stock Options (ISOs)

ISOs offer special tax-favored treatment but must comply with **strict requirements** under IRC § 422.   Here are some of the key requirements:

- ISOs may be **granted only to employees** of the company granting the option (or certain related companies). Independent contractors and other non-employees are not eligible to receive ISOs. Note that foreign talent may not benefit from the tax advantages of ISOs, even if they are employees.

- ISOs must be granted under a **written plan** that meets specific requirements and is approved by the company's shareholders within a certain timeframe.

- The **strike price must be equal to or greater than the per-share fair market value** on the grant date. *For individuals who qualify as 10% shareholders, the strike price must be*

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at least 110% of the shares' fair market value on the grant date.

- **No more than $100,000 worth of ISOs** (based on the shares' fair market value on the grant date) can first become exercisable in any calendar year.

- ISOs **must be exercised within 10 years** of the grant date *(five years for options granted to 10-percent shareholders)* **or, if sooner, within three months after an option holder is terminated for any** reason, subject to special rules for qualifying disabilities and death. Options exercised beyond these timeframes will convert to NSOs and lose favorable tax treatment.

- Once an ISO is exercised, **holding period requirements must be met** to avoid a "disqualifying disposition" and maintain tax-favored treatment. Specifically, a disposition must not occur until at least two years have passed since the grant date and at least one year has passed since the exercise date.

Stock options that qualify as ISOs provide **significant tax advantages**:

- **Favorable Tax Treatment on Exercise.** When an individual exercises an ISO, it is not a tax event (except as described below). Accordingly, the option holder will not pay capital gains tax or ordinary income tax on the "**spread**," meaning the difference between the strike price and the market value of the shares purchased on the exercise date. This also means that, upon exercise, ISOs are not subject to payroll taxes or withholding obligations for the employer.

Beware of AMT Risk. Despite the tax benefits described ab when an ISO is exercised, the IRS treats the spread at exerc alternative minimum tax (AMT) income**. In some scenarios, can cause an ISO holder to owe AMT in the year of exercis creating a significant tax liability for the individual before have liquidity to pay it.** This AMT risk is one of the most su and costly traps related to ISOs.

- **Capital Gains Tax at Disposition.** After an ISO has been exercised, the only federal tax applicable upon a qualifying disposition is long-term capital gains tax.

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However, the company does **not** receive a tax deduction when an employee exercises an ISO or when it is eventually sold (unless the employee makes a disqualifying disposition).

Snapshot of Nonstatutory Stock Options (NSOs)

- NSOs are options that are **not** granted under an ISO plan or an ESPP.
- They can be granted to **employees or non-employees**, such as directors, consultants, or independent contractors.
- NSOs have **more flexibility** than ISOs but receive **less favorable tax treatment:**
    - In the year of exercise, **the spread is taxed as ordinary income**, and that amount is also subject to payroll taxes and withholding requirements. However, if the option agreement permits early exercising and NSOs are exercised immediately or before they have vested, the individual may, but is not required to, file a Section 83(b) election within 30 days of the exercise date. **A timely filed 83(b) election may help reduce or eliminate ordinary income tax liability in the year of exercise since the per-share fair market value may not have increased much, if at all, between the grant date and the early exercise date.** (However, a restricted stock grant can accomplish the same tax savings with a less complicated structure and may be the preferred equity compensation tool for start-ups.)

> **Note on Rare NSOs.** Generally, NSOs are not taxable at the grant because the tax applicable to property transfers unde Section 83 does not apply to the transfer of an option witho readily ascertainable fair market value (RAFMV), which mea options are either actively traded on an established market otherwise meet strict (and extremely uncommon) conditior Treas. Reg. § 1.83-7(b)(2). In the rare event that an NSO has RAFMV at the time of grant, taxation under Section 83(a) w apply at the time of grant.

    - However, the **employer may take a tax deduction** equal to the amount of the ordinary income recognized in the year of the exercise based on the spread.

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- At disposition, the amount by which the sale price exceeds the fair market value at exercise is subject to **capital gains tax** (either short-term or long-term, depending on the holding period).

Top 5 Considerations for Tech Companies

1. Design Strategy. Choosing whether to offer ISOs or NSOs will require you to consider many factors, such as the type of recipient, your company's stage, compliance burdens, tax implications, and more. For example, early startups may favor ISOs to maximize talent retention, while NSOs allow flexibility for non-employee contributors and foreign hires. However, as the company's per-share fair market value rises, so does the AMT risk for ISOs (as well as the value of the employer deduction for NSOs). **In some circumstances, alternative forms of equity compensation, such as restricted stock awards, might make the most sense.**

2. 409A Valuation. IRC § 409A imposes strict tax rules on "nonqualified deferred compensation plans," and violations can create compliance nightmares for employers and significant penalties for individual participants. While ISOs are usually exempt from Section 409A and NSOs can be carefully structured to qualify as exempt, underpricing options and other mistakes can inadvertently trigger 409A. It is therefore critical for you to get independent and up-to-date 409A valuations before granting options and document everything.

3. Future Exit Implications. Option grants affect equity structure and future liquidity events. Each grant dilutes existing shareholders, which may impact M&A valuations, employee morale, or investor perceptions. Make sure to maintain a clean cap table and option ledger, in addition to clearly documenting all ISO/NSO terms and valuations – and expect this area to be scrutinized during due diligence. In addition, you should design option agreements from the start to address potential exit scenarios, such as whether certain change-in-control events trigger accelerated vesting or other alternative outcomes.

Want more? Check out our prior FP insight: 10 Steps for Bu
Sell Tech Startups to Lock Down Employment Law Compli

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4. Employee Education and Communication. Employee misconceptions around stock options can lead to unpleasant surprises, costly disputes, and reputational damage. You can help avoid this outcome by educating employees and clearly communicating with them throughout the lifecycle of their options. Employees must understand that options are not ownership, do not guarantee compensation (even if exercised), may be subject to, as applicable, forfeiture, cancellation, expiration, or certain restrictions (even if fully vested), and can trigger significant tax liabilities (even if liquidity never occurs). Be especially clear (in both the governing documents and employee communications) about any forfeiture triggers, when exercise windows expire, and what happens upon terminations and changes in control. Managers should also be trained to direct employee questions to Human Resources to avoid misstatements regarding stock options and prepared to respond to general inquiries during the hiring process.

5. Coordinated Legal Compliance. Employee stock options can implicate a broad range of federal, state, and local laws – from tax rules to securities regulations to wage and hour, equal pay, and other workplace laws. You should adopt a coordinated approach that involves legal, HR, finance, and company leadership to ensure both compliance and strategic goals are met.

Conclusion

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