Stock Option Fundamentals

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The stock option backdating controversies seem to be waning. Even the IRS has suggested as much. The IRS recently announced it was on the verge of removing backdating options from its so-called Tier I issue list. Tier I issues require significant input from IRS management teams and must be audited and resolved along strict guidelines. If the IRS does downgrade option backdating, it may be the end of a mini-era. It may therefore be an opportune time to review some basics, and to do it from the holder's viewpoint.

From a stock option holder's perspective, how are NSOs and ISOs are treated in transactions? If one sets aside as a subset the golden parachute rules, there is still plenty to know and do when dealing with outstanding ISOs and/or NSOs held either by the acquiring or the Target company.

Can't We All Just Get Along?

From a stock option holder's perspective, an interesting question is how NSOs and ISOs are treated in transactions. If one sets aside as a subset the golden parachute rules, there is still plenty to know and do when dealing with outstanding ISOs and/or NSOs held either by the acquiring or the Target company.

In many transactions, the buyer and Target will agree that the Target's obligations under its options plans will be assumed by the buyer. Often, substitute options to purchase buyer's stock will be swapped for the outstanding options to purchase the Target stock. But, what about taxes?

Generally, the buyer will be able to make this substitution so that the employee/optionholders are not taxable on this substitution itself. In such a substitution, the Target's optionholders will generally be able to preserve the gain inherent in their old Target options, while maintaining a continuing stake in the appreciation of the ongoing (post-acquisition) enterprise.

Given the elaborate regime for ISOs—and (by comparison) the loosey-goosey rules

for NSOs—ISOs and NSOs need to be separately considered in an analysis of assumptions and substitutions of options.

Assuming/Substituting ISOs

Where the Target has outstanding ISOs, one huge concern will be preserving the qualified ISO status of those options. Some option plans contain hidden traps that would disqualify the ISO treatment. For example, the Target's plan may provide that ISOs vest automatically on a change in control.

This could cause a large number of options to lose ISO status because of the $100,000 annual dollar cap on ISOs. It is also important to ensure that the assumption does not result in a "modification" of the ISOs. Modification here is a technical term with (perhaps not surprisingly) negative consequences.

A modification may occur if the option terms change, giving the employee additional benefits. The reason the determination whether an ISO is modified is so important is what happens if it is treated as modified: the option is treated as reissued as of the date of the modification. [On this point, *see* Code Sec. 424(h)(1); Reg. §1.425-1(e)(2).]

This reissuance treatment means the option will be retested as of that moment to see if it satisfies all of the ISO requirements. Recall the long list of requirements that must be satisfied for an option to qualify as an ISO. It is a fairly odious list. For a variety of reasons, especially the fair market value of the underlying shares in the context of a merger or acquisition, it may well exceed the option exercise price and thus preclude ISO treatment if this retesting must occur.

What's a "Corporate Transaction"?

If an ISO is substituted or assumed in a "corporate transaction," that substitution or assumption is not treated as a modification if:

- the new option satisfies a "spread test" and a "ratio test"; and
- it does not provide additional benefits that were not provided under the old option.

Before defining the spread and ratio tests, let's look at what constitutes a "corporate transaction." Two conditions must be met before a transaction will be considered a corporate transaction.

First, the transaction must involve one of the following: a merger or consolidation; an acquisition of property or stock by any corporation; a spin-off, split-up or split-off; or a reorganization or any partial or complete liquidation. [*See* Code Sec. 424(a); Reg. §1.425-1(a)(1)(ii).] Note that it is irrelevant whether the transaction qualifies as a tax-qualified reorganization under Code Sec. 368. The second requirement is that the transaction must result in a significant number of employees being transferred to a new employer or discharged. Plainly, there can be debates about the relative meaning of the term "significant number of employees" here.

Ratio and Spread Examined

Assuming a corporation transaction (as defined) has occurred, the assumption or substitution of the ISO will be fine, as long as both the "spread" and "ratio" tests are met. The spread test is met if the aggregate spread of the new option (immediately after the substitution or assumption) is not more than the aggregate spread of the old option immediately before the substitution or assumption. This "spread" is the excess of the aggregate fair market value of the shares subject to the option over the aggregate option price for those shares. [*See* Code Sec. 424(a)(1); Reg. §1.425-1(a)(1)(i).]

The "ratio" test is met by doing a share-by-share comparison. The ratio of the option price to the fair market value of the shares subject to the new option immediately after the substitution or assumption must be no more favorable to the optionee than the ratio of the option price to the fair market value of the shares subject to the old option (immediately before the substitution or assumption). This spread test is only regulatory (it does not appear in the Code itself). Examples in the Regulations help explain and illustrate both the spread and the ratio tests. [*See* Reg. §1.425-1(a)(4).]

Predictably, there are some determinations to be made in assessing whether these tests are met. For both tests, the parties may adopt "any reasonable method" to

determine the fair market value of the stock subject to the option. Stock listed on an exchange can be based on the last sale before the transaction or the first sale after the transaction, as long as the sale clearly reflects the fair market value.

Alternatively, an average selling price may be used during a longer period. The fair market value can also be based on the stock value assigned for purposes of the deal (as long as it is an arm's-length deal).

Additional Benefits No-No

Even if one gets over the "corporate transaction" hurdle, the "spread" hurdle and the "ratio" hurdle, someone must also analyze the transaction to determine whether the new option provides any "additional benefits" to the optionholders. If it does, the ISOs assumed or substituted will be a problem.

The new option must not provide the optionholder with additional time to exercise or more favorable terms for paying the exercise price. Significantly, though, shortening the period during which the option may be exercised (or accelerating vesting) are not treated as additional benefits. The acceleration of vesting exception is an important one and is widely used.

If You Cancel the ISOs

Although the rules regarding assumption of ISOs are complex (actually, more complex than the above brief summary indicates) and a variety of issues can come up in that context, cancelling ISOs turns out to be remarkably simple. The tax consequences on a cancellation of ISOs are governed by Code Sec. 83.

If the ISO does not have a readily ascertainable fair market value at the time it was granted, then Code Sec. 83 requires that the cash or property received in cancellation of the option be treated the same as if the cash or property were transferred pursuant to the exercise of the option. [*See* Reg. §1.83-7(a).]

Thus, if the cash or property received on cancellation is fully vested, then the optionholder would recognize income on the cancellation of the option equal to this amount (less any amount paid by the optionholder to acquire the option, typically nothing). This income constitutes wages subject to withholding for income and employment taxes and will generate a corresponding deduction to the company.

Where the property received in exchange for the option (on its cancellation) is not substantially vested (let's say restricted stock is used, for example), then the cancellation transaction will not be taxable until the property becomes substantially vested. Again, these are the rules set out in (and in the regulations underlying) Code Sec. 83. Consequently, it should be possible for the employee to elect to take the property even before substantial vesting into income by making a Code Sec. 83(b) election.

If You Hold NSOs

What if you hold NSOs instead of ISOs? The treatment of NSOs in a transaction, as with the initial issuance of NSOs, is a good deal simpler than the rules for ISOs.

If a buyer wishes to assume the Target's NSOs, one looks to Code Sec. 83 to determine the tax consequences to both the optionholders and the company. Recall that Code Sec. 83 does not apply to the grant of an option without an ascertainable fair market value. If an employee exchanges an NSO that does not have a fair market value in an arm's-length transaction, the question is what he or she gets. Code Sec. 83 will apply to the transfer of the money (or other property) received in exchange.

Thus, if the new NSO received in exchange for the old NSO does not have a readily ascertainable fair market value, the employee will not recognize income in the exchange, nor will the company get a deduction. Of course, NSOs may have some value when they are issued.

Yet, this value is generally not readily ascertainable unless the option is actively traded on an established market (unlikely). Assuming it is not actively traded on an established market, it will not have a readily ascertainable value unless all of the following exist for the option:

- It is transferable.
- It is immediately exercisable in full.
- It (or the property subject to the option) is not subject to any restriction or condition,

other than a lien or other condition to secure payment, that has a significant effect on the fair market value of the option.

- Its fair market value is readily ascertainable in accordance with the regulations. [*See* Reg. §1.83-7(b).] Most NSOs do not satisfy all four of these conditions, so don't have a readily ascertainable fair market value.

Unlike ISOs, with an NSO there is no need to focus on whether the assumption or substitution of the NSO results in a "modification." NSOs are simpler and more flexible. There is simply no qualified status to interrupt.

Thus, the holder of an NSO should not recognize income where the terms of the new option are different than the terms of the old. This is somewhat of a murky area, though.

For example, suppose the new option has an exercise price that is nominal in relation to the fair market value of the underlying shares. Here, the optionholder may have to recognize the income on the transaction. If the buyer chooses to give the optionholder an alternative, to convert the option into an option in the buyer, or to take cash (or other property) for the option now, the situation is also easier with NSOs than with ISOs.

Someone choosing cash will recognize income in an amount equal to the amount of cash received, less any amount paid for the option (but the amount paid is most typically zero). An optionholder who elects not to take cash should not be taxed.

If You Cancel NSOs

One place where the rules for ISOs and NSOs are remarkably parallel concerns cancellation. Although most of the complexity associated with the treatment of options (either ISOs or NSOs) in merger and acquisition transactions involves assumptions and substitutions, not too much can go wrong when it comes to a cancellation.

If the NSOs are simply canceled in the deal, then the employee looks to Code Sec. 83 to determine how he or she is taxed. Remarkably, this is the same set of rules that will apply when an ISO is cancelled. Thus, the above discussion concerning cancellation of ISOs applies to cancellation of NSOs as well.

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