To Deduct or Capitalize Option Costs

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It hardly takes a microscope to spot deduction versus capitalization issues in acquisitions. If stock options are canceled as part of a transaction (either ISOs or NSOs), one question is whether the payment attributable to the cancellation is deductible. The amount at stake is the cash or property used to cancel the options.

Suppose that the company issues a Form W-2 to each pertinent employee treating the cancellation payment as wages. There is little question that the payment is properly deductible. Happily, the gremlins of *INDOPCO,* SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039 (1992), have apparently not reached this particular area. Indeed, in a surprising show of largesse, the IRS has even ruled that the following items can be deducted notwithstanding *INDOPCO*:

- A bonus paid to option holders to compensate them for the loss of ISO status as a result of the deal
- The cancellation of unvested options
- The portion of any cancellation payment attributable to a premium paid for stock of the target

Good News

All these are deductible, not capital, expenditures. Of course, one cannot get carried away with this logic. If options were issued as a result of the sale or acquisition of the business or in connection with some other transaction that is by its nature capital, then the payments may not be currently deductible. This is a variation of the origin-of-the-claim doctrine (which applies in litigation recoveries, among other areas).

How are NSOs and ISOs treated in transactions? Setting aside the golden parachute rules, there is still plenty to know when dealing with outstanding ISOs and/or NSOs held either by the acquiring or the target company. In many transactions, 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 stock will be swapped for the outstanding options to purchase target stock.

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. Of course, there is an elaborate regime for ISOs and, by comparison, very liberal rules for NSOs. As such, ISOs and NSOs must be separately considered when analyzing assuming or substituting options.

Assuming/Substituting ISOs

Where the target has outstanding ISOs, one concern will be preserving their qualified ISO status. Some option plans contain hidden traps that would disqualify 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 annual $100,000 ISO cap.

It is also important to ensure that the assumption does not result in a "modification" of the ISOs. *Modification* here is a technical term, and it has negative consequences. A modification may occur if the option terms change, giving the employee additional benefits. The reason determining 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. [*See* Code Sec. 424(h)(1); Reg. §1.424-1(e)(2).]

This reissuance treatment means the option will be retested to see if it satisfies all of the ISO requirements. Recall the long list of requirements that must be met 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, the options may well exceed the option exercise price and thus preclude ISO treatment if this retesting must occur.

Specialized Meaning of "Corporate Transaction"

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

- 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 for a transaction to 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, a reorganization, or any partial or complete liquidation. [*See* Code Sec. 424(a); Reg. §1.425-1(a)(1)(ii).] It is irrelevant whether the transaction qualifies as a tax-qualified reorganization under Code Sec. 368.

Second, the transaction must result in a significant number of employees being transferred to a new employer or discharged. There can be debates about the relative meaning of the term "significant number of employees."

Even if one can surmount the corporate transaction, spread, and ratio hurdles, that is not enough.

Spread and Ratio Tests

If a corporate transaction 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 in the regulations, not in the Code. 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 determinations to be made in assessing whether these tests have been 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.

Even if one can surmount the corporate transaction, spread, and ratio hurdles, that is not enough. 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.

Cancelling ISOs

The rules regarding assumptions of ISOs are complex—considerably more complex than the preceding brief summary indicates. Indeed, a miscellany of issues can come up in working through an ISO assumption. In contrast, cancelling ISOs turns out to be remarkably simple.

The tax consequences of a cancellation of ISOs are governed by Section ("Code Sec.") 83 of the Internal Revenue Code. If the ISO does not have a readily ascertainable fair market value at the time it was granted, Code Sec. 83 provides for simple parity. The cash or property received for cancellation of the option must be treated as if the cash or property had been transferred pursuant to the exercise of the option. [*See* Reg. §1.83-5(b).]

That means if the cash or property received on cancellation is fully vested, 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.

When the property received in exchange for the option (on its cancellation) is not substantially vested (if restricted stock is used, for example), the cancellation transaction will not be taxable until the property becomes substantially vested. Once again, these are the rules set out in Code Sec. 83 and its regulations. Consequently, it should be possible for the employee to elect to take the property into income even before substantial vesting by making a Code Sec. 83(b) election. [For coverage of Code Sec. 83(b), *see* Wood, *Repurchase Nuances and Code Sec. 83*, M&A TAX REP., Oct. 2009, at 4; Wood, *Code Sec. 83(b) Elections: The Good, the Bad and the Ugly*, M&A TAX REP., Oct. 2008, at 1.

Treatment of NSOs in Transactions

As with the initial issuance of NSOs, the treatment of NSOs in a transaction is a good deal simpler than 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. Of course, Code Sec. 83 generally 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 receives in return.

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, but this value generally is not readily ascertainable unless the option is actively traded on an established market.

Assuming it is not actively traded on an established market, the option will not have a readily ascertainable value unless the option has all of the following characteristics:

- 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. Thus, they do not have a readily ascertainable fair market value.

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Unlike with ISOs, with an NSO there is no need to focus on whether the assumption or substitution of the NSO results in a "modification." In the case of NSOs, there is simply no qualified status to interrupt. Thus, the holder of an NSO should not recognize income even when the terms of the new option are different from the terms of the old.

This is a somewhat 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. In such a case, the optionholder may have to recognize income on the transaction.

But what if the buyer chooses to give the optionholder an alternative, say to convert the option into an option in the buyer or to take cash (or other property) for the option now? The situation is 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. Of course, the amount paid is typically zero. An optionholder who elects not to take cash should not be taxed.

Cancellation of NSOs

One area in which the rules for ISOs and NSOs are remarkably parallel concerns cancellation. Most of the complexity associated with the treatment of options (both ISOs and NSOs) in merger and acquisition transactions involves assumptions and substitutions. In contrast, not too much can go wrong when it comes to a cancellation.

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

Accounting Treatment Change

Finally, there can be accounting issues on a modification. Under Financial Accounting Standards Board Interpretation Number 44, *Accounting for Certain Transactions Involving Stock Compensation*, an assessment should be made as to whether the proposed modification changes the life of the employee stock options. The duration of the option could be changed through an extension of the exercise period or a renewal of the exercise period. The assessment should also determine whether the modification changes the exercise price of the employee stock options or the number of shares the employee is entitled to receive.

A modification that does not affect the life of the stock option, the exercise price, or the number of shares to be issued has no accounting consequence. In most cases, a modification of this type would not affect the life of the stock option, the exercise price, or the number of shares to be issued. Accordingly, a new measurement date would not be deemed to have occurred.

Conclusion

Handling outstanding options in an acquisition may not be the most interesting or dynamic part of the transaction. Nevertheless, these are important pieces of the puzzle. With both ISOs and NSOs, it pays to pay attention.

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