MORSE

Extending the Exercise Period of a Stock Option

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From time to time an employer may consider changing the terms of a stock option granted to an employee. This article explores the tax impact of one such change in greater depth, namely, the extension of the exercise period of a stock option. In short, a corporation may extend the period during which an employee may exercise a stock option without adverse tax consequences in two situations: (A) at the time the option is "underwater" or (B) if the extension does not run beyond the earlier to occur of (i) 10 years from the date of original grant of the stock option and (ii) the latest date the option could have been expired by its original terms. A corporation extending a stock option outside of these two situations must tread with care, however, as such an extension may cause adverse tax consequences to the employee, as described below.

Q: Can a corporation extend the time period to exercise an employee's stock option without adverse tax consequences to the employee?

A: To answer this question we need to know a few additional facts:

1. Is the option an incentive stock option (ISO) or a nonqualified stock option (NQO)[1]?
2. What is the exercise price of the option?
3. What is the fair market value (FMV) of the underlying stock at the time of extension?
4. What is the latest date the option could terminate by its original terms?

An extension, of course, is the granting of additional time to exercise an option beyond the time prescribed by the option's original terms. Option grants typically provide that the employee may exercise the option any time (to the extent vested) before the 10th anniversary of the grant[2] of the option, unless, before such 10th anniversary, the employee separates from service, or she dies or becomes disabled. Many plans provide, in the case of separation, death or disability, that the employee (or her estate or conservator) must exercise within three months to a year of the date of such event or the option terminates.

The situations in which an extension is contemplated vary. For example, an employer might desire to give a terminating employee (or her estate or conservator) more time to obtain the funds to pay the exercise price or an opportunity to exercise all or a portion of the option in a later year in order to spread out or lower tax liability. A longer exercise period might also enable the employee to exercise in conjunction with a sale, IPO or other liquidity event of the corporation which is anticipated to occur after the end of the original exercise period. In most cases, the employer desires to extend the exercise period rather than grant a new option in an attempt to preserve a low original exercise price. In each case, the employer may consider an extension the right thing to do or a concession to keep the departing employee happy.

Whatever the reason, the answers to the questions posed above will determine whether the corporation can extend the option without creating a tax problem for the employee. As a preliminary matter, it is important to determine whether the option is an ISO or NQO. The rules for the tax treatment of an extension are different for ISOs and NQOs.

ISOs

If the option is an ISO, the extension will be treated as the grant of a "new option." Whether the "new option" meets all the requirements for ISO treatment is reevaluated at the time of the extension. If the extended ISO again satisfies ISO characterization, it will be treated as a new ISO. If the extended ISO fails ISO characterization upon reevaluation (which will be the case if the stock has appreciated since original grant), it will be treated as a NQO *from the date of original grant*.

Why is this determination important? One reason is expectations. The employee might expect to continue to have favorable ISO tax treatment after the extension. If an option is treated as an ISO, the employee will not pay income tax[3] on exercise of the ISO and, assuming post-exercise ISO holding periods are satisfied[4], will pay income tax on all appreciation at favorable capital gains rates (currently 20% at the federal level) upon later sale of the stock. By comparison, if an option is treated as a NQO, the employee will have income equal to the difference between the exercise price and the fair market value of the stock typically upon exercise.[5] This income will be taxed at ordinary income tax rates (which may be as high as 39.6% at the federal level). Upon the later sale of the stock, assuming she holds the stock for more than one year, any additional gain will be subject to the lower capital gains rates. Another reason ISO-NQO characterization is important is Section 409A of the Internal Revenue Code. If the option is re-characterized as a NQO, it must also be analyzed under Section 409A, a complex set of tax rules which may cause adverse tax consequences to the employee in certain situations.

<u>NQOs</u>

To understand the tax impact of an extension of a NQO (or, for purposes of the discussion below, an ISO treated as a NQO upon extension) one must understand a bit about Section 409A. A NQO granted (i) with an exercise price at least equal to FMV at the time of grant and (ii) without a "feature for the deferral of compensation" is exempt from Section 409A.[6] This is the "holy grail" for NQOs — an employee holding a "409A-exempt" NQO is not taxed until she exercises the NQO. On the other hand, a NQO that is not "409A-exempt" upon grant must be drafted as of grant so that it is "409A-compliant" (as described below) or else the employee will be subject to a parade of tax horribles imposed by Section 409A. Among these "horribles" are ordinary income inclusion (even before exercise of the NQO) at the end of each tax year equal to the spread between the exercise price and the then current FMV[7], a 20% penalty on the spread, and a penalty interest.

In general, an extension of a NQO will be treated as if the option had a "feature for deferral of compensation" *going back to the time of original grant*. This means that the extension will cause a previously"409A-exempt" NQO to be subject to Section 409A for all time, not just going forward. Thus, unless the NQO happened to be "409A-compliant" since its original grant or unless an exception (discussed further below) applies, the adverse tax consequences of Section 409A will result from the extension.

To be "409A-compliant" the exercise of the extended NQO must have been restricted *since the time of original grant* to one of a handful of events permitted under Section 409A or the first to occur of such events. Permitted exercise events under Section 409A include the employee's separation from service, disability, death, a time or fixed schedule, a change in control, or an unforeseeable emergency.[8] As mentioned previously, the terms of original grant of NQOs typically allow the employee discretion to exercise at any time after the option vests and during the option term. The employer has no ability at the time of extension to fix a NQO so that it is"409A compliant" going back to the date of grant in order to avoid Section 409A penalties.

<u>What is an Employer To Do?</u>

If the employer must extend a NQO (or an ISO treated as an NQO upon extension), all may not be lost. There are important exceptions to the unfavorable treatment of NQO extensions. Specifically, it is not an "extension" and, thus, not a "feature for the deferral of compensation" if:

- At the time of extension, the NQO is "underwater"; or
- TheexerciseperiodoftheNQO is not extended beyond the earlier of:
  - The latest date the option could have expired by its original terms and
  - The 10th anniversary of the grant of the option.

Note: in the first case (an "underwater" NQO), the extension is treated as the grant of a new option, which most likely would qualify as a new ISO or a 409A-exempt NQO. In the second case (an extension within the earlier of the two periods described), the extended period is simply not treated as an "additional feature of deferral", the NQO continues to be treated as 409A-exempt since original grant.
These are handy exceptions which can provide the employer and employee with the flexibility needed to achieve their goals. Taking advantage of these exceptions requires knowing the answers to Questions 2-4 above regarding, the original exercise price, the new FMV and the original term of the option.

If these exceptions do not apply, there is limited relief when an extension causes an option to be subject to adverse tax consequences under Section 409A. Fast action is required as the employer must rescind the extension by the earlier of the date the stock right is exercised or the last day of the year in which the employer extended the option.

Conclusion

Changes to option terms, including the extension of the option exercise period, raise important tax issues. While alternatives for extension exist that do not result in adverse tax consequences to the employee, an employer considering an extension should seek advice of tax counsel before making such a change.

For further information on this topic, please contact a member of our **Tax Practice Group**.

Footnotes:

1 This analysis assumes that if the option is a NQO, then the NQO is exempt from Section 409A of the Code (as more fully discussed herein) as of original grant.

2 If the option is an ISO, the exercise period must be no longer than 10 years.

3 She may be subject to the AMT tax, however.

4 The employee must not dispose of the shares received upon exercise prior to 2 years from the date of grant of the option and 1 year from the date of exercise of the option.

5 Section 409A, discussed below, may accelerate the time the employee must recognize the income.

6 The NQO must also be granted with respect to "service recipient stock" by an "eligible issuer of service recipient stock". Discussion of these terms is beyond the scope of this article.

7 Only to the extent the NQO is vested and the "spread" was not previously included in income by the employee at the end of a prior tax year.

8 Care must be exercised in drafting the exercise events, as not all terminations constitute a 409A-compliant "separation from service" and not all sales constitute a 409A-compliant "change in control."