

Equity Compensation Masterclass

SESSION 2 Stock Options--ISOs and NQSOs

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FINANCIAL EXPERTS
NETWORK

CORE FEATURES OF STOCK OPTIONS

Right to purchase stock granted by company to individual under terms of stock plan and grant agreement

Exercise option to buy specific number of shares at set price during specified time period

Usually cannot be exercised until satisfy vesting period—some private companies grant early exercise options

After exercise in public company, you own shares and can sell, gift, pledge or hold

CORE FEATURES CONT'D

Two types—NQSOs and ISO with tax differences

Expire at end of term (usually 10 years from grant date) and no longer able to exercise options

Termination of employment usually stops or impacts vesting and triggers post-termination exercise rules

Rules may vary for some life situations such as death, disability, retirement, leave of absence and M&A depending on terms of stock plan and grant agreement

RESTRICTED STOCK/RSUS VS STOCK OPTIONS

Restricted Stock/RSUs	Stock Options
Value depends on stock price at vesting even if price falls after grant	Value depends on any stock price increase over exercise price set at grant
No payment to receive shares	Pay exercise price to buy shares
Restricted stock (not RSUs) have dividends and voting rights during vesting period	Receive dividends and voting rights only after exercise option
Own shares upon vesting/delivery	Own shares upon exercise
Taxation at vesting unless file 83(b) election to be taxed on value at grant (not available for RSUs)	Taxable income for NQSOs at exercise and for ISOs at sale—more control over timing of taxation

VESTING FEATURES

Vesting usually time-based—provide services for company for specified period from grant date

Vesting schedule may also be performance based—tied to company specific criteria or stock market targets. More common with restricted stock/RSSUs

Vesting schedule may be cliff, graded or hybrid

Cliff—100% vesting only after 4 years

Graded—25% vesting each year for 4 years

Hybrid—25% vesting after one year, then monthly/quarterly vesting through year 4

EXERCISE METHODS

Cash

Cashless Same Day Sale—no cash paid at exercise, receive net cash and no shares—simultaneous exercise and sale

Sell to Cover—no cash at exercise, receive net shares and no cash—sell enough shares to cover cost of exercise and tax w/holding

Stock Swap—no cash at exercise, use previously owned shares to exercise

Net Exercise—no cash at exercise—use some shares would otherwise receive to cover exercise cost

Promissory Note, Bank Loan, Third Party Funding

NON-QUALIFIED STOCK OPTIONS (NQSOS)

FEATURES OF NQSOS

NQSOS are most common type of option

Can be granted to employees, directors, officers, consultants and other service providers

Does not qualify for special tax treatment

“Non-Qualified” refers to tax treatment that exercise triggers

FEATURES OF NQSOS CONT'D

- ▶ Spread at exercise taxable income and fixed regardless of what stock does after exercise
- ▶ All taxes apply as with salary—federal, state, Social Security/Medicare taxes apply to spread
- ▶ Withholding occurs at exercise at set rates 22/37% for supplemental wage income—often too low
- ▶ Income and withholding appear on W-2—Box 12 Code V shows amount of income
- ▶ When sell shares, capital gains on appreciation over stock's value at exercise or capital loss if price declined—holding period starts day after exercise

NQSO TAXATION TIMELINE



NQSO TAXATION EXAMPLE

1/1/2024 exercise of NQSO—exercise price=\$12, FMV=\$18

Spread—difference between FMV at exercise and exercise price—subject to ord inc and withholding at exercise

Ord inc on spread of $\$18 - \$12 = \$6$ —reported on W-2 and withholding for Fed, state and FICA

At sale—any appreciation above FMV at exercise subject to STCG or LTCG depending on holding period since exercise

Sale 10/1/2024 at \$20—for holding period less than one year STCG of $\$20 - \$18 = \$2$

Sale 2/1/2025 at \$24—for holding period more than one year LTCG of $\$24 - \$18 = \$6$

INCENTIVE STOCK OPTIONS--ISOS

FEATURES OF ISOS

ISOs qualify for special tax treatment and filings under the tax code if grant meets certain requirements—Tax forms 3921, 6251 and 8801

ISOs only granted to employees, not to outside directors or consultants

\$100,000 limit on aggregate grant value of ISOs that may first become exercisable in any calendar year—ISOs over that amount become NQSOs. Issues when have multiple grants and with change of control acceleration of vesting

ISO \$100,000 LIMIT

FMV when ISOs first become exercisable (as opposed to actually exercised) in any calendar year cannot exceed \$100,000

Limit determined by FMV of underlying shares on date of grant—usually exercise price—not on vest date

Example—50,000 ISOs with exercise price/FMV on date of grant of \$8 and vesting 25%/year for 4 years—only \$100,000 of value vests each year so all shares are ISOs

If FMV on grant date were \$10, then only 10,000 shares are ISOs and remaining 2,500 shares that vest each year would become NQSOs

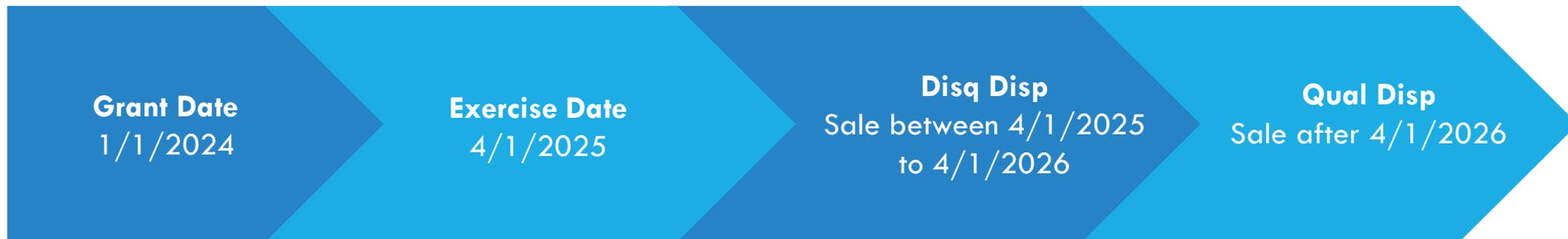
\$100,000 limit applied to full value of ISO award at grant if have early exercise ISOs

ISO TAXATION

Qualifying Disposition--If hold shares received on exercise for more than one year after exercise **and** more than two years after grant, all proceeds above exercise price are LTCG

Disqualifying Disposition—If don't meet either holding period, spread at exercise becomes ordinary W-2 income—if price decreased, no ordinary income and sale treated as capital loss

Example—



ISO TAXATION CONT'D

No tax withholding or FICA tax even upon disq disp—plan for taxes owed

Shares held through calendar year of exercise—spread at exercise part of AMT income calculated on IRS Form 6251

AMT Credit generated when exercise triggers AMT—credit tracked on IRS Form 8801

ISO TAXATION CONT'D

No W-2 income unless have disq
disp

IRS Form 3921 has details of ISO
exercise

Strict rules when ISO turns into
NQSO after termination of
employment

- 3 months after regular termination
- 12 month after disability
- No limit after death

Form 3921 for ISO exercise during the prior year

CORRECTED (if checked)

TRANSFEROR'S name, street address, city or town, state or province, country, and ZIP or foreign postal code		1 Date option granted 1-1-2021	OMB No. 1545-2129 Form 3921 (Rev. October 2017)	Exercise of an Incentive Stock Option Under Section 422(b) Copy B For Employee This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
		2 Date option exercised 4-11-2023		
TRANSFEROR'S TIN	EMPLOYEE'S TIN	3 Exercise price per share \$ 8.00	4 Fair market value per share on exercise date \$ 10.00	
EMPLOYEE'S name		5 No. of shares transferred 1,000		
Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code		6 If other than TRANSFEROR, name, address, and TIN of corporation whose stock is being transferred		
Account number (see instructions)				

Form **3921** (Rev. October 2017) (keep for your records) www.irs.gov/Form3921 Department of the Treasury - Internal Revenue Service

ISO—QUALIFYING DISPOSITION

ISO exercise price=\$15 and exercise when FMV=\$20

Hold for more than two years from grant **and** one year from exercise—
potential AMT based on spread at exercise

If sell at \$30—price higher than FMV on exercise date--\$15 LTCG on sale
and no W-2 inc—full amt above FMV on exercise date taxed as LTCG

If sell at \$18—price higher than exercise price but lower than FMV on
exercise date—excess of sales price over exercise price--\$18-\$15=\$3
LTCG

If sell at \$13—price lower than exercise price and lower than FMV on
exercise date—no W-2 inc and have \$2 LTCL.

ISO—Disqualifying Disposition

- ▶ ISO exercise price=\$15 and exercise when FMV=\$20
- ▶ Hold for less than two years from grant or one year from exercise and sell—no AMT if sale is in same year as exercise
- ▶ If sell at \$30—price higher than FMV and exercise price--\$5 spread at exercise is W-2 inc and amt above FMV at exercise of \$10 is STCG
- ▶ If sell at \$18—price higher than exercise price but lower than FMV at exercise—excess of sales price over exercise price of \$3 is W-2 inc and no cap gain/loss—may have wash sale if repurchase stock w/in 30 days
- ▶ If sell at \$13—price lower than exercise price and FMV at exercise—no W-2 inc and have \$2 STCL

AMT CALCULATION

Calculate regular taxable income and income tax

Calculate alternative minimum taxable income (AMTI) on Schedule 6251—
add back tax preference items such as ISO spread

Subtract AMTI exemption to reduce AMTI

Multiply AMTI by AMT rate—26 or 28%

Compare AMT with regular income tax—pay higher of two amounts

Any excess of AMT over regular tax reported on Schedule 2 of 1040

Any AMT from ISO exercise generates AMT credit to use in future—
calculated on Form 8801

2026 AMT EXEMPTION, PHASEOUTS AND RATES

Filer status in 2026	AMT income exemption amount	Exemption amount phaseout starts	Exemption amount phaseout ends	Point where rate rises from 26% to 28%
<i>Single</i>	\$90,100	Was \$626,350 in 2025 Reverts to \$500,000 in 2026	Was \$978,750 in 2025 \$680,200 starting in 2026	\$244,500 <i>(married filing separately: \$122,250)</i>
<i>Joint</i>	\$140,200	Was \$1,252,700 in 2025 Reverts to \$1 million in 2026	Was \$1,800,700 in 2025 \$1,280,400 starting in 2026	\$244,500

AMT CREDIT

ISO stock that triggered AMT has dual basis and negative adjustment on Form 6251 when sell stock

Once AMT triggered must complete Form 6251 every year along with Form 8801 for AMT credit

Example—if exercise ISO last year and hold through end of year assume triggers \$15,000 AMT and generates \$15,000 AMT credit. If this year regular tax is \$35,000 and AMT \$30,000, can use \$5,000 of \$15,000 AMT credit—excess of regular tax over AMT—and carry forward remaining \$10,000 AMT credit to future years

EXERCISE STRATEGIES FOR NQSOS AND ISOS

NQSOs VS ISO

Option Type	Eligibility	Trigger for Taxation	Taxes	Withholding	Taxation at Sale
NQSO	Employees, execs, directors, contractors, consultants	Exercise	Ordinary compensation income and FICA based on exercise spread	Yes at exercise for comp inc and FICA	Cap gains on sales price above cost basis
ISO	Employees and execs	Sale for income tax and possibly exercise for AMT	Qual disp--No income tax at exercise—possibly AMT—if disqual disp/ord inc tax but no FICA	No, not even on disq disp	LTCG if qual disp/if disq disp ord inc on exercise spread and possible cap gains—outcome varies depending on sales price

CONSIDERATIONS AT GRANT

What type of Option—NQSO /ISO

Grant details—exercise price, vesting schedule, term

If part of employment offer—terms may be negotiable

Documents—plan, award agreement

Methods of exercise—cash, cashless, sell to cover, etc

Possibility of early exercise/83(b) election—private company

Withholding obligation—NQSOs vs ISOs

Job termination provisions—PTEP, retirement eligible

Change of control impact

Company trading restrictions

Concentrated position issues

EXERCISE CONSIDERATIONS

Public vs private company

When to exercise—time until expiration

Spread--FMV – exercise price

Exercise and sell/hold

Tax considerations—compensation income vs cap gains

Are there ongoing grants

Available exercise methods—limited in private companies

Liquidity concerns

Transparency on company finances

EXERCISE OF NQSOS

NQSOS not tax favored as ISOs are—ord inc on spread at exercise

Can defer taxes by delaying exercise until closer to expiration

Generally not best to exercise NQSOS and hold for cap gains

If exercise and hold early in term, lose benefit of leverage—generally more leverage if stock price closer to exercise price

Exercise and hold requires all costs paid out of pocket, take on investment risk and potentially exacerbates concentrated position

Value of option = intrinsic value plus time value

EXERCISE METHODS--NQSOS

Cash—need liquidity to cover cost of exercise and taxes—receive all shares

Cashless/sell-to-cover—use proceeds from selling some or all of shares to cover cost of exercise and taxes

Promissory note—private companies—interest rate at least at AFR and loan should be recourse

Third-party financing for priv co options, e.g., ESO Fund, SecFi, Equity Bee—provide liquidity in exchange for some of upside

Stock swap—using previously owned shares to pay for exercise—replacement/exchanged shares and additional shares

CASHLESS EXERCISE EXAMPLE FOR NQSOs

Exercising 1,000 NQSOs exercise price of 10 and current FMV 30

Costs are exercise price of 10 X 1,000 shares=\$10,000, plus tax liability on spread of 20 X 1,000 shares=\$20,000 ord inc—assume tax rate of 40% (fed, state and FICA)—tax liability=\$8,000

Total cost=\$10,000 for exercise plus \$8,000 for tax liability=\$18,000

Immediately sell all 1,000 shares at current FMV of 30--\$30,000 proceeds

Use \$18,000 of proceeds to cover cost of exercise and tax liability leaving net amount of \$12,000 cash and own no shares

If did sell to cover, instead of cashless, would have net shares of $\$12,000/30=400$ shares

STOCK SWAP EXAMPLE FOR NQSO EXERCISE

Own 1,000 shares from prior NQSO exercise when ex pr was 15 and FMV 40—basis=40

Exercise add'l 1,000 NQSOs at ex pr=30 when FMV=50—need \$30,000 to pay for exercise cost

$\$30,000 / 50$ current FMV=600 already owned shares to pay for exercise

600 previously owned shares exchanged for 600 replacement shares with same basis of 40 and no income tax

Also receive 400 additional shares with basis of 50—income tax on full value of 50×400 shares=\$20,000 ord inc

Spread at exercise= $50 - 30 = 20 \times 1,000$ shares=\$20,000 ord inc

EXERCISE OF ISOS

ISOs are tax-favored compared to NQSOs but may trigger AMT

May exercise and sell if have immediate cash needs or diversification needs—disq disp/no AMT

Exercise and hold can be tax efficient and if also believe stock price will increase—meet statutory holding period for qual disp but possible AMT at exercise

Work with tax advisor to determine how many ISOs can be exercised before triggering AMT liability--laddering ISO exercises over several years

Impact of increased SALT limitation on potential AMT liability—added back to AMT income so number of ISOs exercised lower to reduce spread subject to AMT

Impact on reduced AMT exemption phaseout starting in 2026

Higher income years may allow more room to exercise ISOs—pair ISO exercise with RSUs vesting/NQSO exercise—max AMT rate=28%, max inc tax rate=37%

If have AMT liability—track AMT basis as well as income tax basis

EXERCISE OF ISOS CONT'D

Conservative approach—exercise and sell to capture intrinsic value—disq disp

Moderate approach—exercise some ISOs to hold with little or no AMT liability and exercise and sell remaining ISOs

Staggered approach—continually exercise ISOs each year and sell as soon as each batch satisfies holding period—helps achieve diversification and can recoup some of AMT each time stock sold

Aggressive approach—exercise all ISOs and hold for future appreciation even if generates AMT liability

Benefit of exercising ISOs early in calendar year

ISO EXERCISE EARLY IN YEAR EXAMPLE

100,000 ISOs with exercise price of 5 and current FMV 15

If exercise all ISOs on March 15 in year 1, no current regular income tax but spread of 10 X 100,000 shares=\$1 million AMT preference item

Assume would result in AMT liability of \$200,000

If stock price declines as approach end of year, as long as sell shares prior to Dec 31 of year 1, AMT liability goes away, although now have disq disp

If stock price continues to rise, hold past end of year 1—AMT liability now attaches and due by tax filing deadline of April 15 of year 2

As long as hold shares beyond March 15 of year 2, can now sell some of shares by April 15 of year 2 in qual disp to cover any liquidity needs to pay for AMT liability

STOCK SWAP EXAMPLE FOR EXERCISE OF ISOS

Source of previously owned shares important—mature vs immature shares

Assume use mature shares—satisfied ISO holding period

Own 1,000 shares from prior ISO exercise when ex pr was 15 and FMV 40—basis=15

Exercise add'l 1,000 ISOs at ex pr=30 when FMV=50—need \$30,000 to pay for exercise cost

$\$30,000 / 50$ current FMV=600 already owned shares to pay for exercise

600 previously owned shares exchanged for 600 replacement shares with same basis of 15

Also receive 400 additional shares with basis of 0

No income tax on receipt of replacement and additional shares but potential AMT on 20 spread at exercise—holding period for replacement and additional shares counted from swap date

THANK YOU

Questions?

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