Published on *The National Law Review* https://natlawreview.com

ISOs and Employee Payroll Taxes

Article By:

Matthew B. Grunert

Carolyn A. Exnicios

L. Lee McMurtry III

Business Considerations

Exercising an incentive stock option ("ISO") prior to an M&A transaction that would otherwise result in such ISO being "cashed out" (*i.e*., cancelled at closing with any positive spread paid to the holder) can result in tax savings to the ISO holder. This opportunity for tax savings arises because federal payroll taxes[1] do not apply to the exercise of an ISO, even if that employee disposes of acquired stock shortly thereafter and does not otherwise meet the holding requirements for favorable ISO income tax treatment.

It is not uncommon for outstanding, vested options to be cashed out at the closing of an M&A transaction. Unfortunately for an ISO holder, a cash-out of an ISO is not treated as an exercise of the ISO followed by a sale of stock (which would not be subject to federal payroll taxes); rather, it is treated as cancellation of the ISO in exchange for immediate payment of any positive spread and is fully taxable at closing as compensation income and subject to federal income and payroll taxes (and applicable withholding).

Therefore, an ISO holder may want to consider exercising an ISO prior to closing, rather than having it cashed out, to avoid federal payroll taxes.

Technical Considerations

Upon exercise of an ISO, the holder is not required to recognize any income for federal income or wages for payroll taxes purposes. If the holder then retains the stock acquired on exercise for (i) at least two years from the date the option was granted and (ii) one year from the date the option was exercised, any gain recognized upon the sale of the acquired stock will be eligible for long-term capital gains treatment. However, if the holding period requirement is not met, then a "disqualifying disposition" occurs and the holder will generally recognize compensation income equal to the spread on the date of exercise. In the case of sale of ISO shares in an M&A transaction where the ISO was exercised shortly prior to closing, such a disqualifying disposition will occur. The disqualifying disposition will result in compensation income to holder that will be reported on a Form W-2 and will be subject to federal income taxation (but not withholding); however, such compensation will not be subject to federal payroll taxes.

Several aspects of the ISO rules arise in the context of M&A transactions that are worth noting. First, to the extent that an ISO first becomes exercisable in a particular year with respect to more than $100,000 of stock (with stock value measured as of the ISO grant date), the excess stock above $100,000 is not eligible for ISO treatment. This is important because ISO vesting acceleration as a result of the M&A transaction could result in a portion of those ISOs vesting exceeding the $100,000 limit, resulting in the exercise (or cash-out) of such excess portion being treated as compensation income subject to both federal income and payroll taxes (and applicable withholding). In addition, the exercise of an ISO is normally a preference adjustment for purposes of the federal alternative minimum tax ("AMT"), but this preference adjustment does not apply if a disqualifying disposition occurs in the same year in which the ISO was exercised.

Treasury Circular 230 Disclosure

To comply with requirements imposed by the Internal Revenue Service, we inform you that any advice contained in this written communication (including any attachment hereto) is not intended or written to be used, and cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on the person.

---

1. Federal payroll taxes include Social Security (OASDI) taxes (6.2% on first $127,200 of wages for 2017), the regular Medicare tax (1.45%, no wage cap), the high earner Medicare tax (additional 0.9% on wages above $200,000 ($250,000 for married filing jointly) for 2017) and FUTA (6.0% on first $7,000 of wages for 2017).

National Law Review, Volume VII, Number 179