

# THE STOCK OPTIONS BOOK

**18th Edition**

ALISON WRIGHT

ALISA J. BAKER

PAM CHERNOFF

**Title page and table of contents**

© 2017 by the authors and NCEO.

See [www.nceo.org/r/sob](http://www.nceo.org/r/sob) for more information or to order.

The National Center for Employee Ownership  
Oakland, California

This publication is designed to provide accurate and authoritative information regarding the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Legal, accounting, and other rules affecting business often change. Before making decisions based on the information you find here or in any publication from any publisher, you should ascertain what changes might have occurred and what changes might be forthcoming. The NCEO's website (including the members-only area) and newsletter for members provide regular updates on these changes. If you have any questions or concerns about a particular issue, check with your professional advisor or, if you are an NCEO member, call or email us.

**The Stock Options Book • 18th Edition**

Alison Wright, Alisa J. Baker, and Pam Chernoff

Edited by Pam Chernoff

Indexed by Achaessa James

Book design by Scott Rodrick

Copyright © 2004, 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015, 2016, 2017 by the authors and The National Center for Employee Ownership (NCEO). All rights reserved. No part of this book may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without prior written permission from the publisher.

The National Center for Employee Ownership

1629 Telegraph Ave., Suite 200

Oakland, CA 94612

(510) 208-1300 • (510) 272-9510 (fax) • Web: [www.nceo.org](http://www.nceo.org)

First printed May 1997; reprinted with revisions, January 1998, June 1998. Second edition, February 1999. Third edition, July 1999; reprinted with revisions, December 1999. Fourth edition, June 2001. Fifth edition, October 2002. Sixth edition, January 2004. Seventh edition, January 2006. Eighth edition, January 2007. Ninth edition, February 2008. Tenth edition, February 2009. Eleventh edition, February 2010. Twelfth edition, February 2011. Thirteenth edition, February 2012. Fourteenth edition, February 2013. Fifteenth edition, February 2014. Sixteenth edition, March 2015. Seventeenth edition, February 2016. Eighteenth edition, February 2017.

ISBN: 978-1-938220-49-4

# Contents

**Preface xi**

**Introduction 1**

## **Part I: Overview of Stock Options and Related Plans**

### **Chapter 1: The Basics of Stock Options 5**

- 1.1 What Is a Stock Option? 5
- 1.2 Legal and Regulatory Framework 6
  - 1.2.1 Tax Law 7
  - 1.2.2 Securities Law 8
  - 1.2.3 Accounting Rules 9
  - 1.2.4 Miscellaneous Laws 11

### **Chapter 2: Tax Treatment of Nonstatutory Stock Options 13**

- 2.1 Grant and Exercise Price 13
- 2.2 General Tax Rule 14
- 2.3 Application of Section 83 of the Code 15
- 2.4 Section 83(b) Election 17
- 2.5 Application of Section 409A of the Code 20
- 2.6 Employer Deduction 21
- 2.7 Accounting Treatment 22

### **Chapter 3: Tax Treatment of Incentive Stock Options 23**

- 3.1 Statutory Requirements for ISOs 24
- 3.2 Analysis of Statutory Requirements 26
  - 3.2.1 ISO Plan Must Be Properly Adopted 27
  - 3.2.2 Amendment of ISO Plan Must Be Properly Approved 28
  - 3.2.3 Options Must Be Granted Properly 28
  - 3.2.4 ISOs Are Only for Employees 29

- 3.2.5 Option Exercise Price for ISOs **31**
- 3.2.6 Limitation on Size of Option **33**
- 3.2.7 Limitation on Term of Option **34**
- 3.2.8 Payment for Option Shares **35**
- 3.3 Taxation of ISO Stock **35**
- 3.4 Alternative Minimum Tax Issues **38**
  - 3.4.1 Effect of AMT on ISOs **39**
  - 3.4.2 Effect of Disqualifying Dispositions on AMT **40**
  - 3.4.3 When to File a Section 83(b) Election for ISO AMT **40**
  - 3.4.4 Background on the AMT **41**
- 3.5 Modifying Statutory Options **43**

## **Chapter 4: Plan Design and Administration 49**

- 4.1 General Considerations for the Company **50**
  - 4.1.1 Plan Perspective **51**
  - 4.1.2 Grant Perspective **52**
  - 4.1.3 Grant Acceptance **53**
- 4.2 ISOs or NSOs? **56**
- 4.3 Plan-Level Shareholder Approval Considerations **57**
  - 4.3.1 When Is Shareholder Approval Required? **58**
  - 4.3.2 Stock Exchange Rules **59**
    - 4.3.2.1 Shareholder Approval of Plans **59**
    - 4.3.2.2 Independence of Compensation Committee and Advisors **62**
  - 4.3.3 Proxy Advisor Influence **63**
- 4.4 Say-on-Pay Votes **64**
- 4.5 A Note on Plan Amendments **65**
- 4.6 International Planning Considerations **66**
- 4.7 Grant Timing **68**
  - 4.7.1 What Is Option Backdating? **70**
  - 4.7.2 Grant Timing: Spring-Loading, Forward-Dating, and Bullet-Dodging **72**
  - 4.7.3 Consequences of Backdating **73**
    - 4.7.3.1 Tax Consequences **74**
    - 4.7.3.2 Accounting Consequences **75**
    - 4.7.3.3 Securities Law Consequences **76**
  - 4.7.4 Suggestions for Avoiding Backdating in the Future **77**

**Chapter 5: Employee Stock Purchase Plans 79**

- 5.1 Statutory Requirements for Section 423 Plans 80
- 5.2 ESPP Design 84
  - 5.2.1 ESPP Design Vocabulary 84
  - 5.2.2 Statutory Design Limits for Section 423 Plans 85
  - 5.2.3 Typical Structure of an ESPP: Payroll Deduction Plans 88
    - 5.2.3.1 Enrollment Procedures/Participation Level 89
    - 5.2.3.2 Offering Period Structure 92
  - 5.2.4 Participating in a Section 423 Plan After Termination 96
- 5.3 Tax Consequences 96
  - 5.3.1 Employee Income Taxes 97
  - 5.3.2 Employer Taxes 100
  - 5.3.3 Quirky Tax Outcomes for Section 423 Plans in Down Markets 101
- 5.4 International Planning Considerations 102

**Chapter 6: Trends in Equity Compensation: An Overview 105**

- 6.1 Aligning Equity Compensation with Shareholder Interests: Some Trends 106
  - 6.1.1 Stock Transaction Policies 107
  - 6.1.2 Clawbacks 108
  - 6.1.3 Performance-Contingent Long-Term Incentives 109
- 6.2 Restricted Stock Awards (RSAs) 110
- 6.3 Restricted Stock Units (RSUs) 112
- 6.4 Stock Appreciation Rights (SARs) 115
  - 6.4.1 Tax Issues: Employees 115
  - 6.4.2 Tax Issues: Employers 116
  - 6.4.3 Tandem SARs 116
- 6.5 Phantom Stock 117

**Part II: Technical Issues****Chapter 7: Financing the Purchase of Stock Options 121**

- 7.1 Broker-Assisted Cashless Transactions 122
  - 7.1.1 Tax Issues 123
  - 7.1.2 Insider Issues 124
- 7.2 Net Exercise 125
- 7.3 Stock Swaps 126
  - 7.3.1 Using Nonqualified Shares to Exercise an NSO 128

- 7.3.2 Using Tax-Qualified Shares to Exercise an NSO 128
- 7.3.3 Using Nonqualified Shares to Exercise an ISO 129
- 7.3.4 Using Tax-Qualified Shares to Exercise an ISO 131
  - 7.3.4.1 Using Tax-Qualified Shares for Which the Holding Period Has Been Met 131
  - 7.3.4.2 Using Tax-Qualified Shares for Which the Holding Period Has Not Been Met 133
- 7.3.5 Procedure for Stock Swaps 134
- 7.4 Employer Loans 134
  - 7.4.1 Recourse Notes 135
  - 7.4.2 Collateral 136
  - 7.4.3 Authorization in ISO Plans 136
  - 7.4.4 Providing Adequate Interest 136
  - 7.4.5 Loan Forgiveness 138
  - 7.4.6 Recommendations 138

## **Chapter 8: Overview of Securities Law Issues 141**

- 8.1 State Blue Sky Laws 142
- 8.2 Classification of Companies 143
- 8.3 Federal Securities Rules: Rules 144 and 701 144
  - 8.3.1 Rule 144 Generally 145
  - 8.3.2 Rule 144 Decision Tree 147
  - 8.3.3 Rule 701 149
- 8.4 Federal Securities Rules: Section 16 151
- 8.5 Securities Law Information and Reporting Requirements 153
  - 8.5.1 1933 Act: S-8 Prospectus 153
  - 8.5.2 Exchange Act: Section 16(a) Filings 155
- 8.6 Exchange Act: Equity Compensation Disclosure Rules 156
  - 8.6.1 Executives Covered by Reporting Requirements 157
  - 8.6.2 Compensation Discussion and Analysis 157
  - 8.6.3 NEO Executive Compensation Disclosure Tables and Related Narrative Disclosures 158
  - 8.6.4 Special Disclosure Regarding Stock Options 160
  - 8.6.5 Form 8-K Reporting Requirements 160
- 8.7 ESPP Securities Law Considerations 161
  - 8.7.1 Securities Act of 1933 161
  - 8.7.2 Securities Exchange Act of 1934 162
- 8.8 International Securities Law Issues 162

**Chapter 9: Tax Law Compliance Issues 165**

- 9.1 Tax Withholding for Stock Options 166
- 9.2 Tax Reporting for Stock Options 169
  - 9.2.1 Nonstatutory Options: Form W-2 or Form 1099 169
  - 9.2.2 Statutory Options, Code Sections 422 and 423: Form W-2 169
  - 9.2.3 Form 1099-B 170
  - 9.2.4 FATCA Reporting 171
- 9.3 Section 6039 Information Reporting for Statutory Options 171
  - 9.3.1 Information Required to Be Reported to Optionee 171
  - 9.3.2 Tracking ESPP Qualifying Dispositions 173
  - 9.3.3 Penalties for Noncompliance 175
- 9.4 Procedure for Withholding with Stock 175
- 9.5 Internal Revenue Code Section 409A 177
  - 9.5.1 General Application 178
  - 9.5.2 Specific Application of the Rules to Equity Awards 179
  - 9.5.3 NSOs and SARs 179
  - 9.5.4 Restricted Stock and RSUs 181
- 9.6 Limit on Deductions: \$1 Million Cap  
(Code Section 162(m)) 181
- 9.7 Limit on Deductions: Golden Parachute Rules 185
  - 9.7.1 When Are Options Treated as Parachute Payments? 186
  - 9.7.2 How Are Options Valued for Purposes of Section 280G? 186
- 9.8 Domestic Mobile Employees 187

**Chapter 10: Basic Accounting Issues 189**

*Pam Chernoff and Elizabeth Dodge*

- 10.1 Fair Value and Measurement Date 192
- 10.2 Option-Pricing Models 194
- 10.3 Definition of Employee 197
- 10.4 Recognition of Expense and Application of Estimated Forfeiture  
Rate 198
- 10.5 Equity Compensation Vehicles 200
  - 10.5.1 Stock Options and Stock-Settled SARs with Time-Based  
Vesting 200
  - 10.5.2 Stock Options with Performance Vesting 200
  - 10.5.3 Section 423 ESPPs 201
  - 10.5.4 Restricted Stock Awards and Restricted Stock Units 204
  - 10.5.5 Cash-Settled SARs 204

- 10.5.6 Phantom Stock 205
- 10.6 Tax Accounting 205
- 10.7 Earnings Per Share: Diluted and Basic 207
- Chapter 11: Tax Treatment of Options on Death and Divorce 209**
- 11.1 Death 209
- 11.2 Divorce 211
  - 11.2.1 Option Transfers 212
  - 11.2.2 Tax Treatment on Option Exercise 213
  - 11.2.3 Transfers of Optioned Stock 215
  - 11.2.4 Securities Law Issues 215
  - 11.2.5 Practical Issues 215
- Chapter 12: Post-Termination Option Issues 217**
- 12.1 Using Equity as Severance 218
  - 12.1.1 Acceleration 218
  - 12.1.2 Consulting Agreements 219
  - 12.1.3 Extension of Exercise Period 220
  - 12.1.4 Limitations in the Document 220
  - 12.1.5 Tax Deductions 221
  - 12.1.6 Inadvertent ERISA Severance Plans 221
  - 12.1.7 Related Change-in-Status Issues 221
- 12.2 Forfeiture Clauses: A Note of Caution to Companies That Do Business in California 223

## **Part III: Current Issues**

- Chapter 13: Legislative and Regulatory Initiatives Related to Stock Options: History and Status 229**
- 13.1 Legislative History: Stock Option Initiatives 230
- 13.2 Recent Legislation Affecting Stock Options 231
  - 13.2.1 Sarbanes-Oxley Act of 2002 232
    - 13.2.1.1 Loans to Executive Officers and Directors Are Prohibited 232
    - 13.2.1.2 Forfeiture of Compensation 233
  - 13.2.2 American Jobs Creation Act of 2004 233
  - 13.2.3 Emergency Economic Stabilization Act of 2008 233
  - 13.2.4 Dodd-Frank Act of 2010 235
    - 13.2.4.1 Pay Ratio Disclosure 236



|   |   |            |
|---|---|------------|
| 13.2.4.2  | Clawback Policies   | <b>237</b> |
| 13.2.4.3  | Pay vs. Performance   | <b>238</b> |
| 13.2.4.4  | Requirements Specific to Financial Institutions                 | <b>239</b> |
| 13.2.4.5  | Disclosure of Hedging by Employees, Officers, and Directors     | <b>239</b> |
| 13.2.5  | Jumpstart Our Business Startups Act of 2012                     | 239        |
| <b>Chapter 14: Cases Affecting Equity Compensation</b>            |   | <b>241</b> |
| 14.1  | Tax Cases and Rulings   | 242        |
| 14.1.1  | Tax Decisions in the Courts                                     | 242        |
| 14.1.2  | IRS Rulings and Announcements                                   | 244        |
| 14.1.2.1  | Corporate Matters   | 245        |
| 14.1.2.2  | Individual Matters  | 246        |
| 14.1.2.3  | Stock Plan Administration                                       | 248        |
| 14.2  | Securities-Related Matters                                      | 249        |
| 14.3  | Contract Cases Related to Stock Options                         | 252        |
| 14.3.1  | Waiver, Oral Modification, and Related Claims                   | 253        |
| 14.3.2  | Inconsistent Documents and Ambiguous Language                   | 255        |
| 14.4  | Equity Issues Related to Employment Disputes                    | 259        |
| 14.4.1  | Effects of Termination  | 260        |
| 14.4.2  | Equity as Wages   | 261        |
| 14.4.3  | Noncompete Agreements, Recaptures, and Stock Option Forfeitures | 267        |
| 14.4.4  | Treatment of Equity in Corporate Transactions                   | 268        |
| <b>Chapter 15: Transferable Options</b>                           |   | <b>271</b> |
| 15.1  | Why the Interest in TSOs?                                       | <b>271</b> |
| 15.2  | Limits on TSOs  | <b>272</b> |
| 15.2.1  | Regulations on Option Transfers to Related Parties              | <b>275</b> |
| 15.3  | Recommendations   | <b>276</b> |
| <b>Chapter 16: Reloads, Evergreens, Repricings, and Exchanges</b> |   | <b>277</b> |
| 16.1  | Reloads   | <b>278</b> |
| 16.2  | Evergreen Provisions  | <b>279</b> |
| 16.2.1  | Tax Limitations   | <b>279</b> |
| 16.2.2  | Nonapproved v. Approved Plans                                   | <b>280</b> |
| 16.3  | Repricing Programs  | <b>281</b> |
| 16.3.1  | Corporate Considerations  | <b>281</b> |
| 16.3.2  | Tax Considerations  | <b>283</b> |

- 16.3.3 Securities Law Issues **283**
- 16.3.4 Accounting Issues **285**
- 16.3.5 Stock Exchange Listing Requirements **286**
- 16.3.6 Proxy Advisory Guidelines **286**

## **Appendixes**

### **Appendix 1: Designing a Broad-Based Stock Option Plan 291**

*Corey Rosen*

### **Appendix 2: Primary Sources 311**

- Section 83 of the Internal Revenue Code **312**
- Section 162 of the Internal Revenue Code **314**
- Section 280G of the Internal Revenue Code **321**
- Section 421 of the Internal Revenue Code **325**
- Section 422 of the Internal Revenue Code **327**
- Section 423 of the Internal Revenue Code **329**
- Section 424 of the Internal Revenue Code **332**
- Section 1041 of the Internal Revenue Code **335**
- Section 4999 of the Internal Revenue Code **336**
- Section 6039 of the Internal Revenue Code **336**
- Section 16 of the Securities Exchange Act of 1934 **337**
- SEC Rule 144 **340**
- SEC Rule 701 **354**

### **Glossary 359**

### **Bibliography 369**

### **Index 371**

### **About the Authors 389**

### **About the NCEO 392**