

# Using “In-the-Money” Stock Options Without Violating 409A

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This edition of *The Issue Spotter* examines how in-the-money stock options may be useful to growth companies. For this discussion, “in -the-money” means the strike price is below the fair market value of the underlying stock on the date of grant, and “growth company” means a relatively young private company whose equity and option holders intend to profit from capital appreciation in a sale of the whole company (rather than through distributions of operating profits or isolated equity sales).

## 409A Does Not Prohibit In-The-Money Stock Options

Conventional wisdom says non-qualified options violate §409A unless the strike price is at least equal to the fair market value of the underlying stock on the date the options are granted. Ensuring an “FMV strike price” is generally a good idea of business, securities compliance,

and other non-tax reasons, but it isn’t absolutely required by 409A.

To set the stage, remember that 409A regulates the timing of deferrals and payments for “deferred compensation plans.” Generally, common stock options with an FMV strike price are *not* deferred compensation plans, and are thus *exempt* from 409A. Needless to say, being exempt from 409A means broad flexibility in designing the vesting and exercise provisions for such options, making one’s life a lot easier.

Options issues in-the-money, however, are deferred compensation plans under 409A. While they aren’t *exempt* from 409, they can *comply* with it by, among other criteria, limiting and requiring exercise upon the earliest to occur of one or more of six permissible payment events: death,



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## About BHL&G



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disability, an unforeseen emergency, a specified time or fixed schedule, and, most importantly for growth companies, a change of control or separation from service.

### How In-The-Money Options May Be Useful

Here's what makes in-the-money options a real possibility for

price may be useful in certain circumstances. Most obviously, the company and a new executive may want the executive to share in proceeds from a sale transaction from "dollar one," that is, based on the entire per-share value upon the sale rather than just the spread between the sale value and the exercise price. Or two or more employees may

significant is the issue of "subsequent deferral." Subject to some rare exceptions, in-the-money options (like all deferred compensation plans) *must* be exercised or cashed out upon the relevant payment event, even if the option holder doesn't receive sufficient cash to pay the resulting taxes. For instance, the change of control may be a

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growth companies: very few option holders ever actually exercise their options prior to a liquidity event or, to a lesser extent, a termination of employment. It's only a slight exaggeration to say that a typical option holder would barely notice if his or her options could only be exercised on the earlier of a change of control and/or separation from service. With such restrictions on exercise, the options could comply with 409A even if the strike price were below the fair market value of the underlying stock when granted.

While not normally the preferred approach, options with a nominal or below FMV strike

join the company and receive options at different times but, for various reasons, wish to receive similar equity compensation packages. Startup advisors will recognize another example: a founder may have verbally promised options to certain employees, and the company may even have adopted an option plan and authorize options grants, but the options are never actually granted to the employees until the company's stock has substantially increased in value.

Complying with, rather than being exempt from, 409A has some distinct disadvantages, which is why "FMV strike price" is more common. Most

stock-for-stock reorganization with no cash consideration, or the separation from service may not include a sufficient severance package. Drafting around this risk may involve additional advance planning and negotiation.

### Takeaway

Issuing stock options with an "FMV strike price" surely makes tax and other legal compliance easier, but it is not absolutely required by 409A. There are circumstances in which in-the-money options may be useful. Such options comply with 409A as long as exercise is limited to and required upon certain events, most notably a change of control or separation from service.

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