

Discounted Stock Options Raise Code Section 409A Considerations

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PRACTICES Employee Benefits and Executive Compensation

Companies generally grant stock options to employees, consultants, or non-employee directors to align their compensation with an increase in company value over time. Prior to the adoption of Section 409A of the Code (“**Section 409A**”), companies often granted options with an exercise price that was less than the fair market value of the common stock on the date of grant. The enactment of Section 409A, however, greatly reduced the practice of granting discounted options to service providers in the U.S. (“**U.S. Service Providers**”), because to avoid a 20% additional tax on the options, the options must either be compliant with Section 409A and only exercisable on a Section 409A permissible payment event (i.e., death, disability, separation from service, change in control, a fixed date or fixed schedule), or only exercisable during the short-term deferral period (as discussed in more detail below).

Recently, however, the desire to grant discounted options to U.S. Service Providers has resurfaced, especially for global companies where its non-U.S. based employees often are able to receive discounted options under such foreign jurisdiction’s law. In the event a company wants to grant discounted stock options to its U.S. Service Providers, the company should first determine whether its equity plan actually permits the grant of discounted options and whether, if it is a publicly traded company, the exchange on which it is listed permits the grant of discounted options. Assuming both the plan documents and exchange permit the grant of discounted options, any discounted option would need to be structured to either comply with Section 409A or meet a Section 409A exception summarized below:

- **Section 409A Compliance:** U.S. Service Provider may only exercise the option on the earliest of the following permitted exercise dates: (i) death; (ii) disability; (iii) qualifying separation from service (as defined by Section 409A); (iv) qualifying change in control (as defined by Section 409A); or (v) fixed exercise date.
- **Section 409A Exception:** Under Section 409A’s short-term deferral exception, the option may only be exercisable up to 2½ months following the end of the tax year in which the vesting occurs (i.e., by March 15th for calendar year tax years).

Further, in order to comply with Section 409A, if the participant does not exercise the option in the tax year when it first becomes exercisable (or, if relying on the short-term deferral exception, in the short-term deferral period), then the option must be immediately forfeited. Due to the concerns and risks described above concerning granting discounted stock options to U.S. Service Providers, the safer approach is to either avoid the use of discounted stock options or to grant alternative equity awards that do not have the same Section 409A restrictions.