NSO Grants

Example

Assume Employee #2 has:
- 50,000 NSOs
- Strike price: $2/share
- Current 409A valuation: $20/share
- IPO price: $40/share

His/Her options are fully vested.

Scenario 1: Exercise Before IPO

Employee #2 exercises their options pre-IPO.

Exercise Cost
50,000 × $2 = $100,000

Taxable Spread
($20 - $2) × 50,000 = $900,000

Unlike ISOs, this $900,000 is immediately taxable as compensation income.
It is reported on their W-2 and subject to:
- Federal income tax
- State income tax
- Social Security (where applicable)
- Medicare taxes
- Local taxes (where applicable)

Estimated Tax Impact for California residents:
Assume combined marginal tax rates of approximately: 53%
- Federal: Up to 37%
- California: Up to 13.3%
- Medicare: 2.35%
- CA SDI: 1.3%

Tax liability: $900,000 × 53% = $477,000

After exercise he/she owns:
- 50,000 shares
- Cost basis becomes $20/share (taxable spread + exercise cost)

Future appreciation can potentially benefit from long-term capital gains tax treatment if the sale occurs one-year after the exercise date.

Assume Oura goes public and shares trade at $40.

Their shares are worth:
50,000 × $40 = $2,000,000

Tax basis is:
50,000 × $20 = $1,000,000

Appreciation:
$1,000,000

Estimated Tax Impact if held for one-year from exercise date:
- Federal: Up to 20%
- California: Up to 13.3%
- Net Investment Income Tax (NIIT): 3.8%

Effective rate ≈ Up to 37%

Tax liability:
$1,000,000 × 37% = $370,000

Total Net outlay: $947,000

Scenario 2: Exercise After IPO

Suppose Employee #2 waits until IPO.

Exercise Cost
50,000 × $2 = $100,000

Taxable Spread
($40 - $2) × 50,000 = $1,900,000

$1,900,000 is immediately taxable as compensation income.
It is reported on their W-2 and subject to:
- Federal income tax
- State income tax
- Social Security (where applicable)
- Medicare taxes
- Local taxes (where applicable)

Estimated Tax Impact for California residents:
Assume combined marginal tax rates of approximately: 53%
- Federal: Up to 37%
- California: Up to 13.3%
- Medicare: 2.35%
- CA SDI: 1.3%

Tax liability: $1,900,000 × 53% = $1,007,000

Total net outlay: $1,107,000

Why Employees Sometimes Exercise NSOs Early

The goal is not usually to save taxes on the current spread.

The goal is to:
- Lock in today's lower valuation.
- Start the capital gains holding period.
- Convert future appreciation from ordinary income to capital gains.