NSO Grants

Example

Assume Employee #2 has:
- 10,000 NSOs
- Strike price: $2/share
- Current 409A valuation: $35/share
- IPO price: $200/share

His/Her options are fully vested.

Scenario 1: Exercise Before IPO

Employee #2 exercises their options pre-IPO.

Exercise Cost
10,000 × $2 = $20,000
Taxable Spread
10,000 x ($35 - $2) = $330,000
Unlike ISOs, this $330,000 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:
Combined marginal tax rates of approximately 53% (assuming total taxable income from all sources is over $1M)
- Federal: Up to 37%
- California: Up to 13.3%
- Medicare: 2.35%
- CA SDI: 1.3%

Tax liability: $330,000 × 53% = $174,900

After exercise he/she owns:
- 10,000 shares
- Cost basis becomes $35/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 Sierra goes public and shares trade at $200/share.
Their shares are worth:
10,000 × $200 = $2,000,000
Tax basis is:
10,000 × $35 = $350,000
Appreciation:
$1,650,000

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

Total tax rate ≈ Up to 37%
Tax liability:
$1,650,000 × 37% = $610,500

Total Net outlay: $785,400

Scenario 2: Exercise After IPO

Suppose Employee #2 waits until IPO.

Exercise Cost
10,000 × $2 = $20,000
Taxable Spread
($200 - $2) × 10,000 = $1,980,000
$1,980,000 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:
Combined marginal tax rates of approximately 53% (assuming total taxable income from all sources is over $1M)
- Federal: Up to 37%
- California: Up to 13.3%
- Medicare: 2.35%
- CA SDI: 1.3%

Tax liability: $1,900,000 × 53% = $1,049,400

Total net outlay: $1,069,000

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.

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