EXECUTIVES WITH EQUITY COMPENSATION

The ISO $100K Rule: When Your Options Aren't as "Incentive" as You Think

A single line in the tax code silently converts a slice of your incentive stock options into ordinary NQSOs the moment you cross a threshold — and most people never see it happen until the tax treatment they were counting on isn't there.

Incentive stock options are prized for one reason: exercise, hold, and a qualifying sale is taxed at long-term capital gains rates instead of as ordinary income. But that favorable status is not unlimited. The code caps how much ISO value can actually *become exercisable* in any single calendar year — and value above the cap is not an ISO at all. It is a non-qualified stock option wearing an ISO grant letter.

This is the **$100,000 rule**, and it catches high earners with large grants precisely because their grants are large. The mechanics are quiet, the reclassification is automatic, and the result changes both what you owe and when you owe it.

THE SHORT VERSION

- Only $100,000 of ISO value — measured at the grant-date strike price — can **first become exercisable** in any one calendar year. Value above that becomes an NQSO automatically.
- The two halves are taxed under different systems: the ISO portion feeds AMT and can qualify for long-term capital gains; the **NQSO portion is ordinary income** at exercise, with withholding.
- Your equity platform often still labels the whole grant "ISO." The reclassification is a matter of law, and it lands on **your return**.
- Acceleration from an acquisition or change of control can collapse several years of vesting into one — **silently blowing the cap** and converting a large block to NQSO.

- The fix is to model the true ISO/NQSO split, AMT, and the California layer **together, before you exercise**.

What the rule actually says

Under Section 422(d), the total **fair market value of stock that first becomes exercisable** as an ISO in any one calendar year cannot exceed $100,000 per employee. The value is measured at the **grant date** — not the exercise date — using the strike price. Anything that first becomes exercisable above that $100,000 ceiling is automatically treated as a non-qualified stock option (NQSO).

Two words carry the weight here: *first becomes exercisable*. The rule is not about how much you exercise. It is about how much *vests into an exercisable state* in a given year. A standard four-year vesting schedule with a one-year cliff can push a large grant over the line in the cliff year without you doing anything at all.

> **THE MECHANISM IN ONE LINE**
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> Grant 40,000 options at a $4 strike, and $160,000 of ISO value becomes exercisable. The first $100,000 (25,000 shares) keeps ISO treatment; the remaining $60,000 (15,000 shares) is an NQSO — in the same grant, from the same paperwork.

Why the split matters

The two halves of that grant are taxed under completely different systems, and confusing them is where the money is lost.

The ISO portion

No ordinary income at exercise. The bargain element feeds the alternative minimum tax calculation, and a qualifying sale down the road is taxed at long-term capital gains rates. This is the treatment executives exercise-and-hold to capture.

The NQSO portion

Ordinary income at exercise on the full spread between fair market value and strike — taxed at your marginal rate, subject to payroll tax withholding, and reported on your W-2. No AMT preference, no qualifying-disposition path. The favorable holding clock that makes ISOs worth the wait simply does not apply to this slice.

The practical trap is that your equity platform often shows the entire grant as "ISO." The reclassification is a matter of law, not of what the grant letter is labeled — and it is your return, not the platform, that has to get it right.

Where the $100K rule collides with everything else

WHY THIS IS NEVER A STANDALONE CALCULATION

The reclassification does not happen in a vacuum. It interacts with the two other forces that govern an equity-comp year — and those interactions are where planning earns its keep.

It changes your AMT exposure

Only the ISO portion generates an AMT preference item. When a large exercise reclassifies part of the grant to NQSO, the ISO bargain element that drives AMT is smaller than the platform suggests — but the NQSO ordinary income is larger. The two systems pull in opposite directions, and modeling one without the other produces a wrong number in both.

Acceleration can silently blow the cap

Change-of-control provisions, an acquisition, or a negotiated acceleration can cause options that were scheduled to vest over several years to **all become exercisable at once**. That collapses multiple years of ISO value into a single calendar year — pushing a grant that would have stayed comfortably under $100,000 annually far past the ceiling, converting a large block to NQSO in the process. Executives sitting on grants tied to a pending deal are the most exposed and the least likely to see it coming.

The order of your grants matters

When you hold multiple ISO grants, the $100,000 test is applied in the order the options were granted. A newer grant can be the one that spills over the cap even when an older grant is the one you intended to exercise. The sequencing is mechanical, and it rewards planning the calendar rather than reacting to it.

The planning moves

WHAT A MODELED APPROACH PROTECTS

Know your real ISO/NQSO split before you exercise

The first task is arithmetic the platform won't do for you: for each vesting year, calculate how much ISO value first becomes exercisable, apply the $100,000 test in grant order, and identify exactly how many of your shares are truly ISOs. Everything else depends on this number.

Time exercises around the reclassification

Once you know which shares are NQSOs, you can decide *when* to trigger that ordinary income — pairing it with a lower-income year, or separating it from a year already crowded with bonus, RSU vesting, or a spouse's income. The NQSO income is going to land; the lever is which year it lands in.

Model the deal before it closes

If an acquisition or liquidity event is on the horizon, the acceleration analysis has to happen *before* the documents are signed. Once options accelerate, the reclassification is locked in. Modeling it early can mean structuring the exercise, or the timing around it, to preserve as much ISO treatment as the schedule allows.

Coordinate with AMT and the California layer

California conforms to the federal ISO/NQSO distinction and runs its own AMT system, so the reclassification ripples through your state return as well. The federal split, the AMT interaction, and the California exposure have to be solved together — as one projection, not three afterthoughts.

> **A WORD ON CASH**
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> The NQSO portion triggers ordinary income and withholding at exercise, whether or not you sell any shares to cover it. An exercise you thought was a quiet ISO hold can produce a real, same-year tax bill in cash — the surprise is not just the character of the income, but its timing.

How I work with executives on ISO strategy

The $100,000 rule is not a reason to avoid exercising — it is a reason to know precisely what you hold before you do. I run the grant-order calculation to separate your true ISOs from the reclassified NQSOs, model the exercise against your full-year income picture and your AMT exposure on both the federal and California sides, and, when a deal is in play, pressure-test the acceleration scenario before it can lock in a result you didn't choose.

If you are holding a large ISO grant — or watching a liquidity event approach — the worst version of this is learning after the fact that part of your "incentive" stock was ordinary income all along. The best version is a deliberate, modeled decision made with the real split in front of you.

If you have an equity-comp exercise on the horizon this year, **schedule a consultation before you act**. We will map your true ISO/NQSO split, model the tax across both the federal and California systems, and build the timing around your full-year picture — so the decision is made on the numbers, not discovered on your return. Call **(858) 754-8277** or email **service@lajollataxcpa.com** to set up a consult.

This article is educational and reflects federal and California rules governing incentive stock options, including the $100,000 first-exercisable limitation under IRC §422(d) and the resulting NQSO reclassification. Figures in examples are illustrative. Tax outcomes depend on your specific facts; nothing here is tax advice for your situation. Please consult a qualified CPA before exercising options.

Natalie C. Papagni, CPA — Tax, Planning & Advisory Services

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4275 Executive Square, Suite 200, La Jolla, CA 92037
(858) 754-8277 | service@lajollataxcpa.com | lajollataxcpa.com