Stock option basics

Understand the differences between incentive, non-qualified stock options

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There are two types of stock options: incentive stock options (ISOs) and non-qualified stock options (NSOs). A company may grant ISOs and NSOs to its employees, but ISOs cannot be granted to non-employees. Options that are granted to non-employee directors, contractors, consultants and advisors can only be NSOs.

"It's important for a company's senior management and directors to understand the differences between ISOs and NSOs to avoid unintended tax consequences," says Jill M. Bellak, a member of Semanoff Ormsby Greenberg & Torchia, LLC.

Smart Business spoke to Bellak about the differences in the two types of options, and how to avoid missteps in granting options to employees and non-employees.

What are the legal requirements to qualify as an ISO?

ISOs must be granted through a written plan approved by a company's stockholders and the plan must limit the number of option shares. The option exercise price must be no less than the fair market value of the shares on the grant date. If the grantee owns 10 percent or more of the company's stock, the exercise price must be no less than 110 percent of the fair market value at the date of grant. An ISO must be granted within 10 years of the date the plan is adopted or the date of stockholder approval, whichever is earlier.

An ISO cannot be exercisable for more than 10 years after the grant date. If the option holder owns 10 percent or more of the company stock, the option cannot be exercisable for more than five years after the date of grant. ISOs may be granted only to a company employee who does not own more than 10 percent of the total combined voting power of the company's stock on the date of grant. The value of vested shares may not exceed $100,000 in any calendar year.

How are ISOs treated for tax purposes?

Unlike NSOs, ISOs receive preferable tax treatment because an option holder will not normally realize any taxable income upon the grant or exercise of an ISO. The tax basis in the stock acquired upon exercise of an ISO equals the exercise price paid for the shares.

In order to qualify for capital gains treatment, the shares acquired upon the ISO being exercised must be held for more than one year from the purchase date and more than two years from grant date. If all conditions are met, the company has no withholding obligations upon exercise of the ISO.

How do NSOs differ from ISOs?

An NSO is any stock option that does not meet all of the requirements to be considered an ISO. NSOs may be granted to any employee, director, contractor, consultant or adviser of a company. There is no limitation on the number of options that may be granted, the exercise price or the term of an option. If the exercise price of an NSO is below the fair market value of the stock on the grant date, the NSO will be subject to section 409A of the Internal Revenue Code of 1986.

How are NSOs treated for tax purposes?

Upon exercise of an NSO, the option holder pays the exercise price and realizes income equal to the difference between the exercise price and the then-current fair market value of the underlying stock. This income is taxed as ordinary income and the company has an equivalent deduction for compensation expense equal to the amount of the spread. If the option holder is a company employee, the company must withhold and remit employee withholding taxes on the income.

When an NSO is exercised, the tax basis in the stock is its fair market value on the date of exercise. Upon a subsequent sale of the stock, the stockholder has a capital gain (or loss) equal to the difference between the tax basis and the subsequent sale price of the stock.

What is the applicability of Section 409A?

Section 409A of the Internal Revenue Code regulates the taxation of nonqualified deferred compensation. It treats 'discounted' stock options as deferred compensation subject to section 409A. Specifically, if a stock option is granted with an exercise price that is less than the fair market value of the stock on the grant date, the option will be treated as deferred compensation and will be subject to 409A, including imposition of a 20 percent additional excise tax. ●