Deciding between incentive and nonqualified stock options

Which stock option plan is right for your company?

Prepared by:

Anne Bushman, Partner, Washington National Tax, RSM US LLP
anne.bushman@rsmus.com, +1 202 370 8213

Michelle Borman, Senior Manager, Washington National Tax, RSM US LLP
michelle.borman@rsmus.com, +1 847 413 4690

Frank Tamai, Manager, Washington National Tax, RSM US LLP
frank.tamai@rsmus.com, +1 213 330 4791

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Stock options are a type of compensation device that provides the right to buy stock at an agreed-upon price (the exercise or strike price). Typically, stock options are subject to vesting events based on time or performance requirements.

Stock options are an effective compensation tool for two reasons. First, because they require an investment by the employee, they reinforce the employee's commitment to the company. Second, because the options provide no benefit to the employee unless the company's stock price goes up, they motivate the employee to increase the company's value.

Companies can choose between two types of stock option plans—incentive stock options (ISOs) and nonqualified stock options (NSOs). Both types grant a holder the right to purchase stock over a future period at a given price, and make the holder a legal corporate owner (shareholder) upon exercise. However, there are considerable differences between the two, which employers must understand in order to make a fully informed choice.

Structure of ISOs and NSOs

To qualify for ISO treatment, stock options must meet all of the following requirements under Internal Revenue Code section 422:

1. The options must be granted to employees.
2. The options must be granted in accordance with a written plan that (a) is approved by a formal vote of shareholders within 12 months before or after the plan's effective date, (b) includes the aggregate number of shares available to be granted, and (c) includes the employees or class of employees eligible to receive options.
3. The options must be granted within 10 years from the date the plan is adopted or the date the plan is approved by shareholders, whichever is earlier.
4. The exercise price must not be less than the fair market value (FMV) of the stock on the date of grant (but see No. 6 below).
5. The term of the options must not exceed 10 years from the date of grant (but see No. 6 below).
6. Options granted to a shareholder who owns 10% or more of the total combined voting stock of the company (or its parent or subsidiary) must have an exercise price of at least 110% of the FMV on the date of grant, and the term of the options must not exceed five years.

7. The options must not be transferable except upon death.
8. The options must be exercised while the employee is still employed or within three months of termination of employment (12 months if the termination is the result of death or disability).
9. There is a $100,000 limit (measured on the grant date) on the value of stock underlying the options that can first be exercised by an employee in any given calendar year. In the case of multiple grants, this limitation is absorbed in the order the options were granted.

An option that does not meet one or more of the above requirements, or exceeds the $100,000 limit, is automatically an NSO. There are no specific statutory requirements to qualify as an NSO (but see section 409A considerations below).

In evaluating which option to provide, the employer must first identify whether any of the ISO requirements are problematic from a business perspective. If so, NSOs would be the appropriate choice. In fact, most option grants are structured as NSOs for their added flexibility.

If the company is amenable to the above ISO requirements, the next factor to consider is differences in tax treatment.

Tax treatment of ISOs

If stock options are designed to meet all of the ISO requirements, the following tax consequences should arise from a **qualified disposition**:

For employees
No income is reportable or includable to the employee at the time of grant. (See section 421 (a)(1).)
No income is reportable or includable to the employee upon the employee's exercise of the option, except as noted below regarding the alternative minimum tax (AMT).
The difference between the exercise price and the FMV of the stock at the time of exercise (i.e., the value spread) is an adjustment for AMT purposes and could cause the employee to become subject to the AMT.
The employee's basis in the ISO stock is equal to the amount paid upon exercise of the options. (See section 421(c)(3)(A).)
The holding period of the stock begins on the date of exercise.
If the stock received upon exercise of the ISO is held until the later of 1) two years from the date the ISO was granted, or 2) one year from the date of exercise, any gain or loss upon disposition of the stock should result in capital gain or loss treatment.

For employers
The employer is not entitled to an income tax deduction at the time of grant or exercise. (See section 421(a)(2).)
There is no compensation income from a qualifying disposition and therefore nothing to be reported on Form W-2 or considered wages subject to income tax withholding or wages subject to payroll taxes (i.e., taxes under the Federal Insurance Contributions Act (FICA); see also "Tax withholding issues" below).
The employer is required to provide an information statement to the employee exercising the ISOs that contains summary information pertaining to the ISO exercise (or a copy of Form 3921) by Jan. 31 of the year following the employee's exercise of the ISOs.
The employer is required to file Form 3921 with the IRS reporting each ISO exercised during the preceding calendar year. The filing is due by Feb. 28 if filed on paper or by March 31 if filed electronically. Electronic filing is required for more than 250 ISO exercises during the preceding year.

If the stock received upon exercise of the ISO is disposed of prior to the later of 1) more than two years after the ISO is granted, or 2) more than one year from the date of exercise, it is treated as a disqualifying disposition of the stock. The following tax consequences arise from a **disqualified disposition**:

For employees

The difference between the exercise price and the FMV of the stock on the date of exercise is considered ordinary income to the employee. However, if the value received by the employee upon disposition is less than the FMV on the date of exercise, the income recognized by the employee does not exceed the difference between the disposition price and the exercise price of the ISO stock. (See section 422(c)(2).)

This income is taxable in the year of the disposition of the stock. It should be noted that certain transfers of stock may not be considered dispositions for this purpose (e.g., the exchange of the ISO stock in a tax-free merger or reorganization transaction, a transfer due to a divorce, a transfer from a decedent to his or her estate, or a transfer by bequest).

The employee's basis in the ISO stock is equal to the amount paid upon exercise of the options, plus the amount taxable as ordinary income due to such a disposition.

For employers

The employer must report the applicable income on the Form W-2 issued to the employee. This allows the employer to take a tax deduction for the same amount.

The income from a disqualifying disposition is not considered wages subject to income tax withholding or wages subject to payroll taxes (FICA); see also "Tax withholding issues" below).

Tax treatment of NSOs

In contrast to ISOs, the tax treatment of NSOs is as follows:

For employees

No income is reportable or includable at the time of grant (assuming the option does not have a readily ascertainable FMV, which it almost never does unless the option itself is traded on an exchange).

The option holder must recognize ordinary income upon exercise of the NSO equal to the difference between the exercise price and the FMV of the stock on the date of exercise (i.e., the value spread).

The tax basis of the stock received upon exercise is equal to the FMV of the stock on the date of exercise. Effectively, the employee or non-employee receives basis for the exercise price paid plus the amount of ordinary income recognized upon exercise.

The holding period for the stock begins on the date of exercise.

A subsequent sale of the stock should be eligible for long-term capital gain or loss treatment as long as the stock is held for more than one year from the date of exercise.

For employers

The employer receives an income tax deduction for the amount of wages recognized by an employee (or income recognized by a non-employee) with respect to the NSO exercise..

This value spread at time of exercise is treated as wages for income tax and FICA tax reporting and withholding purposes with respect to an exercising employee. Box 12 should use code V and provide the compensation amount related to the NSO exercise.

Wage withholding and reporting do not apply to the exercise of NSOs by a non-employee director or consultant.

Section 409A considerations

Section 409A can result in adverse tax treatment if it is applicable to an option grant and the requirements are violated. Section 409A is not applicable to option grants that qualify as ISOs.

Further, section 409A is not applicable to NSOs provided they satisfy all the following requirements of the section 409A stock rights exclusion:

- The exercise price of the option may never be less than the FMV of the stock on the date of the grant.
- The option is granted on employer stock, which must generally be common stock of the employer or a parent company that owns 80% of the employer company.
- The number of shares subject to the NSO must be fixed on the initial date of grant.
- The option does not contain any feature that would defer the taxation of the NSO income beyond the later of 1) the exercise date of the NSO, or 2) the date the stock received upon exercise of the NSO is no longer subject to a substantial risk of forfeiture.
- The NSOs are taxable in accordance with section 83.

Most NSOs are designed to meet these requirements and avoid the application (and potential adverse tax treatment) of section 409A. Most notably, adherence to the stock rights exclusion requirements means that the NSOs must not be granted at a discount (i.e., at an exercise price lower than the current FMV of the stock). Thus, an employer must make a good faith determination of its stock price, and option grants must contain an exercise price at least equal to the FMV.

If an employer is intent on granting NSOs at a discount, the grant of the options can be designed to conform to the requirements of section 409A. However, this would require significant restrictions on the exercisability of the options. The NSOs could not be exercisable at the discretion of the option holder, and the exercise would have to be restricted to certain designated section 409A-permitted payment events. Technical issues related to section 409A-compliant stock options are not addressed in this article.

NSOs that are subject to section 409A and fail to meet those requirements result in taxable income to the option holder **as of the date the options vest**, regardless of whether the options have been exercised. The amount of income equals the inherent appreciation in the options as measured on each Dec. 31, beginning with the year of vesting and continuing each year thereafter until the options are finally exercised. In addition to having to pay tax on this phantom income, the option holder may have to pay an additional 20% tax and a premium interest tax due to the section 409A failure. These taxes are in addition to the regular income tax.

The employer also has potential exposure in that it is required to report the section 409A failure and to collect and remit applicable income tax withholding at the time the section 409A income is triggered. Failure to do so exposes the employer to penalties.

It is important for option grants to be structured to meet the section 409A exclusion requirements or, if necessary, to conform to section 409A. Otherwise, there could be significant adverse tax consequences.

Tax withholding issues

Income from an ISO plan is not treated as wages for payroll tax purposes, while income from an NSO plan is. Payroll tax is the general term for taxes under FICA which include the old-age, survivors, and disability insurance (OASDI) taxes, also known as social security taxes, and hospital insurance tax, also known as Medicare taxes. Therefore, NSO plans require both the employer and the employee to pay payroll taxes on NSO plan payments, including the 1.45% Medicare tax and the 6.2% social security tax (subject to the wage cap on the social security tax portion and potential additional 0.9% tax for the employee Medicare tax portion). Generally, however, the cost of these payroll taxes is more than offset by the NSO-related income tax deduction.

An employer must address how to handle the tax withholding obligations of NSOs, as the exercise of a stock option is generally not a cash transaction, yet the government requires the withholding to be made in cash. That is, there is a stock outflow from the company to the employee, but the employee owes income tax withholding and a portion of the payroll tax liability in cash.

Often, as a condition of exercise, option plans require that the employee pay the employer the cash amount needed to cover the income and payroll withholding tax obligations together with the exercise price. Alternatively, the employee and employer can agree that any required withholding taxes will be withheld from other wages payable to the employee or agree to reduce the number of shares transferred upon the exercise by the value of the withholding obligation. In some cases, the employer may be willing to gross up the benefit by agreeing to cover the withholding costs. However, in such instances, the gross-up itself results in additional taxable wages.

Methods of exercise

A key plan element of both ISOs and NSOs is the method of exercise. Some stock option plans require the exercise price to be paid by the employee in cash, which may be difficult for employees depending on the level of compensation paid in cash and stock. For this reason, many option plans allow for cashless or net exercises, which permit the option grantee to exercise the option and utilize the inherent value in the options to pay the exercise price and applicable withholding taxes (a cashless exercise) or to pay just the exercise price but not the applicable withholding taxes (a net exercise). Since the inherent value of the options is being applied toward the exercise price, this manner of exercise reduces the number of shares actually issued to the option holder. It should be noted that using a cashless or net exercise for ISOs will result in a disqualifying disposition with respect to the number of shares used to cover the exercise price and withholding tax because those shares are effectively immediately sold.

Example: An executive owns vested ISOs on 100 shares of company stock valued at $50 per share with an exercise price of $10 per share. The ISOs allow for a net exercise of the options, and the executive elects to exercise the ISOs using a net exercise. The total value of the 100 options is $5,000 (100 x $50 value per share), and $1,000 of this value is applied as payment of the exercise price. Accordingly, upon exercise of the ISOs, the company issues 80 shares of stock to the executive, as the value of 20 shares was used to pay the $1,000 exercise price. The 20 shares are treated as having been sold in a disqualifying disposition and subject to the tax consequences discussed above. However, as long as the executive retains the 80 shares for more than two years from the date of the original grant and one year from the date of exercise, any gain realized upon ultimate disposition of the 80 shares will be eligible for long-term capital gains taxation.

Some plans allow the exercise price to be paid by means of a stock swap using currently owned shares. If a stock swap is utilized, the gain on the currently owned shares used to pay the exercise price will not normally be taxed currently, but an adjustment will be made to reduce the tax basis in the new shares by the amount of the deferred gain.

Example: An executive currently owns 40 shares of company stock that have a value of $50 per share and a tax basis of $40 per share. The shares are swapped to acquire 100 shares subject to an option with a strike price of $20 per share ($2,000 total exercise price). No additional consideration is needed to exercise the options. Prior to the stock swap, the executive owned 40 shares of stock and 100 options. Following the stock swap, the executive owns 100 shares of the company, 40 of which have a $40 per share tax basis (carryover basis from the swapped shares). The 60 new shares have a $0 basis ($2,000 exercise price minus $400 of gain deferred in the swap minus the $1,600 carryover basis allocated to the 40 swapped shares).

Pros and cons of ISOs/NSOs for employers and employees

ISOs	NSOs
More favorable to the employee:	*More favorable to the employer:*
Allow the recipient to defer any recognition of income until the shares received upon exercise are ultimately disposed of	Allow a tax deduction
The income ultimately recognized is eligible for taxation at more favorable long-term capital gains rates if holding periods are met	More flexible and easier to administer
Avoid payroll taxes	Can be issued to independent contractors
Generally less favorable to the employer:	*Generally less favorable to the employee:*
Generally do not allow a tax deduction	Exercise results in compensation income equal to spread
Less flexible and more difficult to administer	Compensation from exercise is subject to payroll tax

For these reasons, ISOs are more common among startup companies that do not yet have taxable income and have the potential for substantial appreciation in their stock price.

Conclusion

ISOs and NSOs provide distinct choices for an employer when designing and implementing a stock option plan. It is always prudent to have qualified advisors review the stock option plan and grant agreements prior to implementation to ensure the company is aware of the tax consequences and that the terms are consistent with the company's intended objectives.

+1 800 274 3978
rsmus.com

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