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Understanding Stock Options

The Differences Between ISOs and NQSOs

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There are several key differences between incentive stock options (ISOs) and non-qualified stock options (NQSOs) also sometimes referred to as nonstatutory stock options or (NSOs). ISOs can only be granted to employees. NQSOs can be granted to anyone, including employees, independent contractors and directors.

There is typically no income tax event at the time a compensatory ISO or NQSO grant is completed; the differences are found when the underlying options are exercised. When an ISO is exercised, no taxable ordinary income results, although alternative minimum tax may apply. When an NQSO is exercised, however, taxable ordinary income will result if the fair market value of the underlying shares on the exercise date is greater than it was on the grant date. In addition, employee NQSO exercises are subject to withholding for employment taxes.

If the shares acquired upon the exercise of an ISO are held for more than one year after the date of exercise and for more than two years after the date of grant, the gain or loss resulting from a sale or other disposition will be taxed as long-term capital gain (or loss). If a "disqualifying disposition" occurs, (i.e. when there is an earlier sale or other disposition of the ISO shares before the expiration of the holding period described earlier,) the former option holder loses the beneficial ISO tax treatment and the ISO is now taxed as a NQSO, which results in the positive difference between the fair market value of the underlying shares on the grant date and the exercise date being taxed as ordinary income. Unlike a true NQSO, however, the former ISO remains exempt from employment taxes.

Companies can generally deduct, as a compensation expense, the ordinary income recognized by the option holder upon the exercise of a NQSO, or the ordinary income recognized upon the disqualifying disposition of an ISO. If an ISO holder exercises his option after complying with the holding periods described above, the company will not be entitled to claim any tax deduction.

The following table summarizes some of the key differences between ISOs and NQSOs.

	ISO	**NQSO**
Granting Entities:	Corporations	Any form of business entity
Eligibility	Employees only	Anyone, including employees, independent contractors and directors.
Written Plan Document Requirement	Yes	No
Shareholder Approval Required	Yes, within 12 months of adoption of the ISO plan by the company	No. However, California Corporations Code § 25102(o) may require approval of a NQSO plan even though the Internal Revenue Code does not.
Restrictions on Exercise Price	The ISO exercise price must be at least equal to the fair market value of the stock on the grant date. The exercise price must be equal to at least 110% of the grant date fair market value of the shares for a recipient that is a 10% owner.	None. However, if the exercise price is below fair market value on the grant date, the NQSO will be treated as a form of non-qualified deferred compensation that must comply with the stringent requirements of Section 409A of the Internal Revenue Code.

Other Qualification Requirements	ISOs granted to one recipient having an aggregate fair market value of more than $100,000 (based on the grant date value) on the date the ISOs first become exercisable (i.e., vested) are treated as NQSOs for tax purposes. All ISOs must be granted within 10 years of the earlier of plan adoption or stockholder approval. All ISOs must be exercised within 10 years of their grant dates. ISOs granted to 10% owners must be exercised within 5 years of their grant dates. ISOs are not transferable, except upon death. ISOs must be exercised within 3 months of employment ending (or 12 months in the case of disability or death).	None. However, California Corporations Code § 25102(o) may impose additional requirements that are not present in the Internal Revenue Code.
Tax Consequences	No taxable income to employee at the time of grant or exercise. The difference between the fair market value of the underlying shares on the grant date versus the exercise date is an item of adjustment for calculating alternative minimum tax. Provided the post-exercise ISO holding period is satisfied, gain or loss when the underlying shares are sold is treated as long-term capital gain or loss. Disqualifying dispositions result in the loss of favorable tax treatment.	No taxable income to recipient at the time of grant. Upon exercise, the difference between the fair market value of the underlying shares on the grant date and the exercise date is taxed as ordinary income. Income upon exercise is subject to withholding and employment taxes. When the underlying shares are sold, the resulting gain or loss is taxed as capital gain or loss.

Important Information Affecting Employers in California:

Section 25110 of the California Corporations Code generally prohibits the offer or sale of any security in California pursuant to a compensatory benefit plan unless either (i) the offer or sale has been qualified by the California Commissioner of Corporations, or (ii) an exemption is available. These rules generally apply to (i) privately-held companies (which covers companies that are located in California or with equity award recipients that are residents of California), and (ii) public companies that are not listed on a major stock exchange.

California employers issuing options rely primarily on Section 25102(o) of the California Corporations Code ("Section 25102(o)") for the grant of compensatory stock options, including both ISOs and NQSOs. The regulations promulgated by the California Commissioner of Corporations under Section 25102(o) impose a number of requirements on the award of stock options (including NQSOs covering LLC membership interests) above and beyond what is required under the federal Internal Revenue Code, including:

- The option plan must specify the total number of securities that may be issued and the class of individuals eligible to receive options and purchase securities under the plan;
- The exercise period of an option must not exceed 120 months from the date of grant;
- Options and the right to acquire securities under the plan must be non-transferable, except as permitted by Rule 701 under the Securities Act of 1933;
- The number of securities and the exercise price subject to equity awards must be proportionately adjusted in the event of stock splits and similar transactions effected without the receipt of consideration by the issuer;
- Optionees must be permitted to exercise their options until the earlier of (i) the option expiration date, or (ii)(A) at least 6 months from a termination due to death or disability, and (B) at least 30 days from a termination due to any other reason except for cause;
- Equity awards must be granted within 10 years from the earlier of (i) the date the plan is adopted, or (ii) the date the plan is approved by the employer's stockholders;
- The plan must be approved by a majority of the outstanding securities entitled to vote within 12 months before or after the date the plan is adopted or, if later, prior to the grant of any equity award to an individual in California; and
- The employer must make a Section 25102(o) filing with the California Secretary of State no later than 30 days after the first issuance of securities in California in reliance on the Section 25102(o) exemption (late filing or failure to file will not result in the loss of the Section 25102(o) exemption).

For more information on the matters discussed in this *Locke Lord QuickStudy,* please contact the authors:

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