ISOs vs. NSOs

By Tyler Hollenbeck

Although there a number of web resources regarding the distinctions between incentive stock options (ISOs), which can only be granted to employees, and non-statutory options (NSOs),[1] which can be granted to employees, directors and consultants, these resources are often heavy with tax jargon that is difficult to understand. To help entrepreneurs focus on what should be most important to them, we have put together the below quick reference guide.[2]

Tax consequences – to the individual

NSOs

- At date of grant and on dates of vesting, there is no tax to the option holder.[3]
- At date of exercise:
  - The option holder is taxed on any spread gain.[4]
  - Ordinary income tax rates apply, plus employment tax rates if the option holder is an employee.
- At date of sale (or other disposition) of the underlying stock:
  - The option holder is taxed on any gain that accrues following the date of exercise.
  - Capital gain rates apply.

ISOs

- At date of grant and on dates of vesting, there is no tax to the option holder.
- At date of exercise:
  - No ordinary income tax and no employment taxes (but see below).
  - Any spread gain will be treated as income for purposes of calculating alternative minimum tax (AMT), unless the option holder sells or disposes of underlying stock in same calendar year as exercise.
- At date of sale (or other disposition) of the underlying stock:
  - If the sale occurs both more than two years after option grant date and more than one year after the date of exercise (the ISO holding periods), then the option holder is taxed at long-term capital gain rates on the difference between the sale proceeds and the purchase price paid (plus any amounts taxed as ordinary income for AMT purposes as noted above).
  - If the individual does not meet the two ISO holding periods mentioned above, then the excess, if any, of the lesser of (a) the fair market value of stock on date of exercise or (b) the proceeds from the sale, in each case, over the purchase price will be taxed as ordinary income (but employment taxes will not apply). Any additional gain will be taxed at capital gain rates.

Simplified example

For purposes of illustration, assume that, on January 1, 2016, you are granted a fully vested option to purchase 100 shares at a purchase price of $1.00 per share. On January 2, 2017, when the fair market value of the underlying stock is $1.50 per share, you exercise the option and purchase all 100 shares. On January 3, 2018, you sell all 100 shares for $2.00 per share. Assuming an ordinary income tax rate of 39.6 percent, an employment tax rate of 7.65 percent and a capital gain rate of 20 percent, and ignoring state taxes and the complexities of the AMT, the following chart illustrates the disparate tax consequences, under the above scenario, if the option is an ISO versus an NSO.

Event	**Tax on ISO**	**Tax on NSO**
Dates of grant and vesting	None	None
Date of exercise	None	$23.63
Date of sale	$20.00	$10.00
Total	$20.00	$33.63

Tax consequences – to company

NSOs

The company is able to take a compensation deduction equal to the amount taxable as ordinary income to the option holder on the date of exercise. The company, however, will have to pay its share of employment taxes upon exercise. The company will also have an obligation to collect tax withholdings and pay such amounts to the tax authorities.

ISOs

The company is entitled to take a compensation deduction only if the option holder fails to satisfy the ISO holding periods; otherwise, the company is not entitled to a deduction. The company will not have to pay the employer-share of employment taxes and will not have a tax withholding obligation.

Because the tax regulations governing option grants and exercises are highly complex and subject to change, companies considering option grants or employees receiving grants should consult with their attorneys and/or tax advisors before taking definitive action.

[1] Non-statutory stock options are also often called nonqualified stock options.

[2] This overview is intended only as a high-level summary of the current US federal tax consequences.

[3] We have assumed that the purchase price for a stock option is always at least equal to the fair market value of the underlying common stock at the time of grant.

[4] The spread gain is the difference between fair market value of common stock on the date of exercise and the purchase price paid for the option's stock.

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