Should Companies Issue Incentive Stock Options or Non-Qualified Stock Options for Their Employees?

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Equity Compensation is a vehicle for paying employees, directors and other consultants for work they perform for an organization.

The most popular form of Equity Compensation is the Employee Stock Option (ESO).

ESOs come in two major forms that companies need to be aware of prior to making grants to their employees through an equity compensation plan.

The types of employee stock options are Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NQs).

This blog entry is a preliminary discussion about the difference between ISOs and NQs.

What are the Key Differences Between ISOs and NQs?

Incentive Stock Options are ***qualified compensation*** per the Internal Revenue Code Section 422. There are many administrative and tax rules that apply to this type of option.

Non-qualified Stock Options are as the name implies, ***non-qualified*** per IRC Section 422. This means they are less restrictive as to whom they can be granted to and how the administration and taxation takes place.

What are the Administrative and Taxation rules for ISOs?

Incentive Stock Options have administrative rules that can make them very complex to handle for an accounting / payroll department. Below is a list of just some of the rules:

- If ISOs are granted to an individual holding more than 10% of the company’s equity, then the grant price must be at least 110% of the fair market value of the company stock on the grant date.
- ISOs must be granted only to employees and directors of a company. Contractors are ineligible to receive incentive stock options.
- The ***Contractual Term*** of ISOs must be limited to 10 years from date of grant
- ISOs must be exercised with 3 months of termination to still qualify for special tax treatment
- An incentive stock options grant must be approved by the Board of Directors and the Shareholders prior to being granted by the company

There are two types of ***dispositions*** for Incentive Stock Options, ***qualifying disposition*** and ***disqualifying disposition.***

- ***Qualifying dispositions*** occur when the underlying stock is held for at least 2 years from grant date and 1 year from the exercise date.
    - If these rules are not met, then the ISOs are said to have a ***non-qualified***, or ***disqualifying disposition.***

- The major consequence of a disqualifying disposition is that the ISOs lose their special tax status and become treated as non-qualified stock options
- When ISOs have a qualifying disposition, the total amount of gain resulting from the spread between the exercise price and ***stock selling price*** is treated as a ***long-term capital gain*** (beneficial tax treatment)
- The tax treatment of NQs dictates that the spread between the exercise price and ***stock price on the day of exercise*** is treated as ordinary income (W2 or 1099 income), and that when the stock is sold, the difference between the price on day of exercise and final selling price is treated as a short or long-term capital gain depending on how long the stock is held from the day of exercise.

Marginal Tax Rate	39.6%
Long-term CG Tax Rate	20.0%
Total Options	1,000
Grant Date	1/1/2010
Stock Price on Grant	$10.00
Exercise Date	1/2/2012
Stock Price on Exercise	$30.00
Sell Stock	1/3/2013
Stock Price on Selling Date	$60.00
ISO Taxes	$60.00 - $10.00 = $50.00 ; long-term capital gain taxed in 2013 $50.00 X (1 – 20.0%) = $40.00 After Tax Income / Option $40.00 X 1,000 = $40,000 Total After Tax Income *AMT Tax Rules would apply
NQ Taxes	$30.00 - $10.00 = $20.00 ; ordinary income taxed in 2012 $20.00 X (1 - 39.6%) = $12.08 After Tax Income / Option $60.00 - $30.00 = $30.00 ; long-term capital in taxed in 2013 $30.00 X (1 – 20.0%) = $24.00 After Tax Income / Option $12.08 + $24.00 = $36.08 After Tax Income $36.08 X 1,000 = $36,800 Total After Tax Income

What About Determining the Fair Value of ISOs vs. NQs? Is There a Difference in the Fair Value Because of the Tax Treatment?

Determining the ***fair value*** of an ISO or an NQ option is exactly the same for both equity compensation instruments. Even though there is an income value difference for the recipients of employee stock options because of the different tax treatment of ISOs and NQs, ***there is no accounting difference in the fair value***. FASB ASC 718 states that the fair value of options must be determined using at least six variables. They are as follows:

- Underlying Stock Price
- Exercise Price of the Option
- Expected Term of the Option
- Expected Volatility of the Option
- Risk-free Interest Rate
- Expected Dividends of the Company during the life of the Option

Many companies use a closed-form model such as ***Black-Scholes-Merton*** to determine the fair value of their employee stock options. At www.fintools.com/resources/best-practice-series we present a list of the valuation methods used by each of the

Dow 30 companies. Although many companies use Black-Scholes-Merton to value their ESOs, it is only one of the several models that may be used to value employee stock options.

Please check back on www.fintools.com for more information on how we may assist you, not only in the valuation of equity compensation, but also in the administration and financial reporting that is required for these instruments of compensation.

If you have any comments, please feel free to contact us at 610-688-8111 or email miti@fintools.com