Comparing NQSOs vs. ISOs

Zajac GROUP

Has your employer offered you non-qualified stock options (NQSOs) or incentive stock options (ISOs) as part of an equity compensation package? If you're lucky, maybe you even get to choose. That's not typical; usually, an equity offering is what it is. But in case you've been wondering how each works, here's a summary to help you compare NQSOs vs. ISOs.

	Non-Qualified Stock Options (NQSOs)	Incentive Stock Options (ISOs)
Overview	NQSOs are relatively easy to understand, with greater simplicity in how the bargain element (basically, your profit) is taxed at exercise. That said, because the bargain element at exercise is taxed as ordinary income, NQSOs may be less taxefficient, and less preferred, to ISOs.	ISOs are often the more tax-advantaged, but potentially complicated options to manage, especially since they entail planning for alternative minimum tax (AMT) and AMT credit, and qualified/disqualified sales. To obtain these tax benefits, will need to exercise and hold the shares for at least 1 year, or more.
Tax Treatment at Grant	There is no tax impact when you are granted your options.	There is no tax impact when you are granted your options.
Tax Treatment at Exercise of Options	In the year you exercise your options, you'll pay ordinary income taxes on the difference between the exercise (strike) price (usually the stock's fair market value on the grant date), versus the fair market value on the exercise date. The spread is also subject to required Social Security and Medicare tax, if applicable.	In the year you exercise your options, there may or may not be an ordinary income tax impact, subject to if you hold the stock or sell the stock. However, there is a reportable tax event and an adjustment for calculating AMT if you hold unsold shares past calendar year-end. If you exercise and sell ISOs in the same calendar year, you'll likely be subject to tax at ordinary income tax rates.
Cash Flow at Exercise of Options	You can often do a cashless exercise or a "sell to cover," which means you don't need to provide cash to exercise your NQSOs. Instead, exercised shares can be sold at exercise to cover the cost of the stock purchase and potential tax withholdings. A sell to cover will not alter your tax treatment at exercise.	**If you exercise and hold all shares:** You'll need to provide cash to buy stock shares at your exercise price and cover any AMT payments (at tax time, or via estimated tax payments). **If you exercise and sell all shares:** You could reserve some of the proceeds to pay estimated taxes, and the remainder can be used to fund personal financial planning goals. **Hybrid approach:** You could exercise and hold some shares, and exercise and sell others to create a sell to cover.
Tax Treatment at Final Sale of Stock	You'll incur a capital gain or loss at final sale. The gain or loss will be the difference between the stock's final sale price versus its adjusted cost basis (often equal to the strike price PLUS the amount included as ordinary income). The proceeds are subject to short- or long-term capital asset rates, depending on whether you held the shares for a year or less (short-term) or more than a year (long-term) before selling them.	**For a qualified sale:** The final sale is qualified if it's at least two years after the grant AND one year after exercise. If so, the difference between the exercise price and final sales price is taxed at more favorable long-term capital gains rates, PLUS you may be able to recover earlier AMT paid by taking an AMT credit in the year a qualified ISO is sold. **For a disqualified sale:** The final sale is disqualified if it does not meet the qualifying standards. If so, you'll likely pay tax at some combination of ordinary income and capital gain tax rates, subject to the time between exercise and sale. AMT may also be due if you perform a disqualified sale that crosses two calendar years.
Tax Withholdings	At exercise, income taxes are withheld at statutory rates (usually 22%, or 37% if reportable income exceeds $1 million). There is no tax withholding at final sale, so estimated payments may be advised.	There are no income tax withholdings at exercise or at final sale. ISOs are not subject to Medicare or Social Security payroll withholdings either.
83(b) Treatment	If your options are eligible for early exercise, you can file an 83(b) election to pay ordinary income taxes on the spread at exercise, prior to vesting. If your company is early-stage with a low share price, you may pay fewer ordinary income taxes early on, than if you wait. In this scenario, an NQSO may offer more tax-saving opportunities than an ISO.	If your options are eligible for early exercise, you can file an 83(b) election. However, since there are no ordinary income taxes due at exercise, the early exercise is only effective for calculating AMT.
Availability	NQSOs can be offered to employees and others, such as contractors, advisors, etc.	ISOs are only available to employees.
If You Leave the Company	Your ability to exercise remaining options will be subject to the terms in your employment agreement, which may offer a post-termination exercise window or options expiration date.	You'll need to exercise the options within 90 days after termination to retain ISO origin.
Maximums	There are no limits on award amounts.	ISO awards are limited to $100,000/year of exercisable value.
Commonalities	As described above, neither NQSOs or ISOs create a tax event at granting. Both also share similar characteristics with respect to their **grant dates, vesting schedules, exercise (strike) prices,** and **expiration dates**. And both options may expose you to concentration risk, or the risk of having too much wealth concentrated in a single stock. If your **concentration risks** are too high, you may want to prioritize reducing them over optimizing tax-saving opportunities. For example, even if it's less tax-efficient, you may take a disqualified ISO sale, so you can more quickly reduce concentration risk by diversifying the proceeds into other assets as soon as possible.	

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