WHAT are the DIFFERENCES BETWEEN an ISO and NSO

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INTRODUCTION

In my experience at Scalar, I've had the opportunity to work with and value many startup companies. As I've consulted with companies, often I'm asked how an Incentive Stock Option ("ISO") differs from a Non-qualified Stock Option ("NSO"). The short answer is that ISOs are issued to employees and may receive better tax treatment than NSOs, which are typically issued to advisors, directors, consultants, or contractors.

MAIN DIFFERENCE?

It's all about the tax treatment. Recipients of ISOs do not have to pay taxes when they exercise their options (NSO holders do pay taxes at exercise) and receive favorable tax treatment when the underlying share is sold if they meet these qualifications:

01 The stock must be sold at least two years after the option grant date
02 The option must have been exercised at least one year prior to selling
03 The recipient of an ISO must still be an employee or have been an employee within 90 days of selling his or her share.[1]

TAXATION OF AN ISO OR NSO

	ISO	NSO
On the grant date:	There is no tax liability for the employee or the employer	There is no tax liability for the employee or the employer
During or at the end of the vesting schedule:	There is no tax liability for either party	There is no tax liability for either party
On the exercise date:	There is no federal or state income tax due for the employee, but they could be subject to taxes on the spread between the strike price and the fair market value ("FMV") as of the exercise date if they need to calculate their alternative minimum tax ("AMT"). An individual should consult with a tax advisor about calculating their AMT.	The holder will owe federal income taxes for the spread between the strike price and the fair market value ("FMV") at the exercise date. Also, if the NSO holder is an employee they will be subject to employment taxes (Medicare, Social Security, and Federal Unemployment). Also, the employer can claim a compensation tax deduction for the amount that is taxed at federal income tax rates.
On the sale date:	If it has been 2 years since the grant date AND 1 year since the employee exercised the option, they qualify for long-term capital gains tax rates for the difference between the strike price and the sale price. If they don't meet the requirements, they will be taxed at their federal income tax rate on the spread between the exercise price and the sale price. However, if the employee fails to meet the ISO requirements and is be taxed at the federal tax income rate, the employer can use the taxable income as a compensation tax deduction.	The holder will be taxed at long-term capital gains rates on the difference between the FMV when they exercised and the sale price.

Here is an example and infographic to further highlight the possible differences of taxes owed on an ISO and NSO.

A company issues an option on June 30, 2019 with a strike price of $1.00 (the strike price is equal to the FMV). One year later on July 1, 2020, the FMV of the underlying share has appreciated to $3.00, and the holder exercises her option. Another year passes and on July 2, 2021, the company is sold for a price of $5.00 per share.

STOCK OPTIONS

Assumptions*

Federal Income Tax Rate:	32%
Capital Gains Tax Rate:	20%
Employment Tax Rate:	8%

*These are generic assumptions for the purpose of the example. Your respective tax rates may vary.

ISO

Options Granted June 30, 2019

		Taxes owed
Strike Price:	$1.00	N/A
Fair Market Value:	$1.00	
Employee Pays:	$0.00	
Taxes Owed:	$0.00	

12 Months Later

Options Granted July 1, 2020

		Taxes owed
Strike Price:	$1.00	No federal income taxes
Fair Market Value:	$3.00	The spread between $3.00 and $1.00 will be used in your Alternative Minimum Tax ("AMT") calculation
Employee Pays:	$1.00	
Taxes Owed:	$0.00	

12 Months Later

Options Granted July 2, 2021

		Taxes owed
Strike Price:	$1.00	The spread between $5.00 and $1.00 will be multiplied by your Capital Gains Tax Rate (20%)
Fair Market Value:	$5.00	
Employee Pays:	Taxes owed	
Taxes Owed:	$0.80	

ISO Holder Summary

Paid	Earned	Total
$1.80	$3.20	$5.00

NSO

Options Granted June 30, 2019

		Taxes owed
Strike Price:	$1.00	N/A
Fair Market Value:	$1.00	
Employee Pays:	$0.00	
Taxes Owed:	$0.00	

12 Months Later

Options Granted July 1, 2020

		Taxes owed
Strike Price:	$1.00	The spread between $3.00 and $1.00 multiplied by the sum of your Federal Income Tax Rate (32%) and your Employment Tax Rate (8%)
Fair Market Value:	$3.00	
Employee Pays:	$1.00 + Taxes	
Taxes Owed:	$0.80	

12 Months Later

Options Granted July 2, 2021

		Taxes owed
Strike Price:	$1.00	The spread between $5.00 and $3.00 will be multiplied by your Capital Gains Tax Rate (20%)
Fair Market Value:	$5.00	
Employee Pays:	Taxes owed	
Taxes Owed:	$0.40	

NSO Holder Summary

Paid	Earned	Total
$2.20	$2.80	$5.00

In this simplified case, the holder would see ~14% higher earnings holding ISO vs NSO.

There is a third scenario that is common and potentially the least tax advantageous where the holder of an ISO is disqualified from the preferred ISO tax treatment because she doesn't meet the three qualifying requirements.

Using the same example as above, if the employee did not exercise her options early, but rather waited until the company was sold for $5.00/share, she would pay ordinary income tax rates rather than long-term capital gains tax rates on her exit proceeds. Add in employment taxes, and she may actually owe more than a comparable NSO holder who also exercised on the date of sale. See the appendix for a table with the calculations.

Other Important Characteristics of an ISO or NSO

ISO/NSO: Both options will have an expiration date set by the employer.

ISO: If an ISO holder tries to exercise more than $100,000 worth of ISOs in one year (strike price multiplied by the number of options being exercised) the surplus will be treated as NSOs, thus triggering additional tax liabilities.

CONCLUDING THOUGHTS

Receiving an ISO can provide an employee with the option to receive the most advantageous tax treatment. Also, for those receiving stock options, either ISOs or NSOs, it is more complex than it appears to be on the surface. It's important for an employee that is receiving an ISO to consult with a professional to maximize the value that ISOs can provide.

How can Scalar help? Scalar values companies to determine the fair market value of their shares through a 409A valuation. This allows a company to set the strike price for options. The 409A valuation is a crucial part of the process whether a company is issuing options, employees are exercising options, or employees are selling their shares. In each of these events, it's necessary for a company to know the FMV of its shares to help mitigate potential tax penalties or additional tax liabilities for itself and its employees.

Due to the everchanging and complex nature of tax regulation surrounding granting options, exercising options, and selling shares, please consult with your attorney, tax professionals, or auditors. This article is purely informative, and Scalar does not accept any responsibility for action taken based on the content of this article.

For more information, follow Scalar on LinkedIn, Twitter, Facebook and Instagram. If you need valuation services, request a complimentary consultation or call us at 385.831.1010.vices, request a complimentary consultation or call us at 385.831.1010.

[1] – Internal Revenue Code Section 422. https://www.law.cornell.edu/uscode/text/26/422

APPENDIX

Incentive Stock Option						
Date	**Description**	**Strike Price**	**Fair Market Value**	**Difference**	**Tax Liability**	**Tax Calculation**
6/30/2019	Option Granted	$1.00	$1.00	$0.00	$0.00	N/A
7/1/2020	Option Exercised	$1.00	$3.00	$2.00	*$0.00	N/A
7/2/2021	Share Sold	$1.00	$5.00	$4.00	$0.80	$4.00 x 20%

*The spread may be considered in calculating the AMT of the employee

	Paid by Employee	Total Received by Employee	Total Tax Liability	Total Value to Employee
ISO Holder Totals	**$1,000.00**	**$5,000.00**	**$800.00**	**$3,200.00**
Calculation	$1.00 x 1,000 Options	$5.00 x 1,000 Options	$0.80 x 1,000 Options	$5,000 - $1,000 - $800

Non-qualified Stock Option						
Date	**Description**	**Strike Price**	**Fair Market Value**	**Difference**	**Tax Liability**	**Tax Calculation**
6/30/2019	Option Granted	$1.00	$1.00	$0.00	$0.00	N/A
7/1/2020	Option Exercised	$1.00	$3.00	$2.00	$0.80	$2.00 x (32% + 8%)
7/2/2021	Share Sold	$1.00	$5.00	$4.00	$0.40	($5.00 - $3.00) x 20%

	Paid by Employee	Total Received by Employee	Total Tax Liability	Total Value to Employee
NSO Holder Totals	**$1,000.00**	**$5,000.00**	**$1,200.00**	**$2,800.00**
Calculation	$1.00 x 1,000 Options	$5.00 x 1,000 Options	($0.80 + $0.40) x 1,000 Options	$5,000 - $1,000 - $1,200

Disqualified Incentive Stock Option						
Date	Description	Strike Price	Fair Market Value	Difference	Tax Liability	Tax Calculation
6/30/2019	Option Granted	$1.00	$1.00	$0.00	$0.00	N/A
7/2/2021	Option Exercised & Share Sold	$1.00	$5.00	$4.00	$1.60	$4.00 x (32% + 8%)

	Paid by Employee	Total Received by Employee	Total Tax Liability	Total Value to Employee
***ISO Holder Totals**	**$1,000.00**	**$5,000.00**	**$1,600.00**	**$2,400.00**
Calculation	$1.00 x 1,000 Options	$5.00 x 1,000 Options	$1.28 x 1,000 Options	$5,000 - $1,000 - $1,280