**Incentive Stock Options (ISOs) versus Nonstatutory Stock Options (NSOs)**

Because ISOs and NSOs are both stock options, they have several similarities, as detailed below:

* Both represent an option holder’s right to purchase a set number of shares of the company at a set exercise price (the “option price”) over a specified exercise period.
* The option price is only paid upon exercise of the option in exchange for shares.
* Transferable only by death via the option holder’s estate.
* Vesting permitted (but not required).
* No voting rights until exercised.
* No tax consequences until exercised provided the requirements regarding option pricing are followed.

Of course, there are also differences between ISOs and NSOs, which are detailed below:

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|   | **ISOs** | **NSOs** |
| ***To whom can they be granted?*** | Employees only.\* | Anyone—including employees, consultants and directors. |
| ***Are there restrictions on the option price?*** | Yes – by statute, the option price cannot be less than the fair market value at the time of the grant. | Yes – usually, the option price should equal the fair market value at the time of the grant. If desired, you can set the option price lower than fair market value, however, this will subject you to Section 409A of the Internal Revenue Code.\*\* |
| ***Are there restrictions on timing?*** | Yes – the option must be granted within 10 years of the adoption of the option plan, and the exercise period cannot be longer than 10 years from the date of the grant. | No – but there is typically a maximum 10-year exercise period. |
| ***Are there restrictions on the amount that can be given?*** | Yes – during each calendar year, an employee may only vest in $100,000 of ISOs (based on the fair market value at the time of grant). Anything vesting in a calendar year over this threshold is treated as an NSO. | No. |
| ***Are they taxed at exercise?*** | No – but the spread between the exercise price and the fair market value at the time of exercise may be subject to alternative minimum tax. | Yes – the difference between the fair market value at the time of exercise and the option price is treated as ordinary income and is subject to income tax and, if the optionee is (or was) an employee, withholding. |
| ***Are they taxed on sale?*** | Yes – if all holding period requirements\*\*\* are met, the sale is taxed at capital gains rates. | Yes – if the stock received upon the exercise of the option is held for more than one year after exercise, the sale is taxed at capital gains rates. |

\* If at the time of grant the employee owns more than 10% of the voting power of the company or any subsidiary, the option price must be increased to at least 110% of fair market value, and the exercise period must be decreased to a maximum of five years from the date of grant.

\*\* If an option award is subject to IRC § 409A, failure to comply with that statute’s provisions can subject a company and the option holder to significant tax consequences, including taxation at the time the option vests (even if unexercised), a 20% excise tax and a penalty rate of interest on any underpayments of tax.

\*\*\* To qualify for capital gain tax on sale, you must hold the stock received upon the exercise of your option for the greater of a) two years from the grant date; and b) one year from exercise. If you sell before this time, the difference between the option price and the fair market value at exercise (or sale, if lower) is taxed as ordinary income, and appreciation above fair market value at the date of exercise is taxed as a capital gain.