NQO's vs. ISO's

"Profits can be made with less risk only when the opportunity is available and not just because they happen to be desired or needed- willingness and ability to hold funds uninvested while waiting real opportunities is a key to success in the battle for investment survival."

-Seth Glickenhaus

There are two types of options that employers typically grant their employees. The first type are known as "Non-Qualified" Stock Options (NQO's). The value of an NQO is included in the employee's income at the time of grant and the employee is taxed at ordinary income rates on the difference between the exercise price and the fair market value of the stock on the date of exercise.

The second type of option issued by employers are known as Incentive Stock Option (ISO's) and their value, conversely, is not included in the employee's income at the time of grant. Generally, there is no tax event with Incentive Stock Options until the stock is received from the exercise of the option is sold. If the stock is held for two years from the date of grant and one year from the date of exercise, then when the stock is sold, the difference between the sale price and the exercise price is taxed at the long-term capital gains rate. However, depending your tax status, the Alternative Minimum Tax (AMT) may apply.

Further differences between the two types of options arise when looking at the potential transactions surrounding the options. Below is a study based on the scenario from page one, where options are granted with a $15 strike price and the options are exercised while the underlying stock trades at a market price of $40 per share. The first thing you will notice is the difference in net proceeds at the end of the transaction. In both scenarios, ISO's provide the greater initial benefit to the investor.

The second item to be mentioned that is not so readily visible are tax consequences for each type of option. While many agree that US tax codes are complicated to the degree that most Americans cannot complete their own income tax returns, things can get increasingly obscured when options are involved- Matters of timing, change in residency and other ownership related nuances can prove be beyond the capacity of most public accountants who are general practitioners. Most executives would be well-served by a CPA that has a competency in equity based compensation.

Exercise and Sell

# of Options Exercisable	10,000
x Strike Price	$15/ps
= Total Option Cost	**$150,000**
# of Shares	10,000
x Current Market Price	$40/ps
= Gross Proceeds from Sale	**$400,000**

Treatment of Non-Qualified Options (NQO's)

Gross Proceeds from Sale	$400,000
(-) Total Option Cost	-$150,000
(-) Applicable Taxes	-$100,000
= Net Proceeds	**$150,000***

* *Assumption of 40% current tax rate (Includes Federal and FICA)*

Treatment of Incentive Options (ISO's)

Gross Proceeds from Sale	$400,000
(-) Total Option Cost	-$150,000
= Net Proceeds	**$250,000**

Exercise and Hold

# of Options Exercisable	10,000
X Strike Price	$15/ps
= Total Option Cost	**$150,000**
# of Shares	10,000
x Current Market Price	$40/ps
x 50%	X 50%
= Dollars Available for Margin	**$200,000**

Treatment of Non-Qualified Options (NQO's)

Dollars Available for Margin	$200,000
(-) Total Option Cost	-$150,000
(-) Applicable Taxes	-$20,000
= Money Available for Reinvestment	**$30,000***

* *Assumption of 40% current tax rate (Includes Federal and FICA)*

Treatment of Incentive Options (ISO's)

Dollars Available for Margin	$200,000
(-) Total Option Cost	-$150,000
= Money Available for Reinvestment	**$50,000***

* *May be subject to the Alternative Minimum Tax*

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Specific to Employee Stock Options, we help clients to answer the most important question- when to sell. We track ownership and vesting schedules, facilitate Rule 144 transactions, and help to implement advanced strategies for employees with concentrated equity positions.

We hope this information has been both helpful and educational. If you would like further information regarding exercising your equity options or more sophisticated investment strategies, please call us at:

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Further Reading

The Stock Options Book, *by Alisa J. Baker*

Your Employee Stock Options, *by Alan B. Ungar*

Consider Your Options: Get the Most from Your Equity Compensation, *by Kaye A. Thomas*

Glossary:

Employee Stock Options: An option or contract to purchase a specific number of shares of a company at a specific price.

Incentive Stock Option (ISO): A type of option created by the Economic Recovery Tax Act of 1981 (ERTA), in which qualifying options are not taxed at either the grant date or exercise date. Later changes in tax law (sic. Alternative Minimum Tax) have added the taxation effect for some investors however.

Margin: The ability to borrow against collateralized securities. Margin accounts are governed by "Regulation T", the Financial Industry Regulation Authority (FINRA), the New York Stock Exchange, and by house rules of the various brokerage/investment firms.

Non-Qualified Stock Options (NQO): A type of option that does not meet the Internal Revenue Service criteria for special tax treatment. This type of option triggers a taxable event on exercise.

Strike Price: Price at which the stock underlying the Employee Stock Option can be purchased.

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