Corporate Insights: Stock Option Basics

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Most people know that a stock option is a right granted by a corporation to a person that gives that person the right to purchase stock in the corporation under specified conditions and at a specified price. This article summarizes some basics about stock options.

There are two types of stock options: Incentive Stock Options ("ISOs") and Non-Qualified Options ("NQSOs").

ISOs and NQSOs have differing tax consequences, to both the employer and the employee. Generally, the employee who receives an ISO does not realize taxable income at the time of grant or at the time of exercise. Instead, in general, the employee is taxed at the time of disposition of the underlying stock. The gain may constitute capital gain, rather than ordinary income, if the employee has held the underlying stock until the later of two dates: the date that is two years after the grant date, and the date that is one year after the exercise date. If the holding period is not met, the disposition is called a "disqualifying disposition." In that event, a portion of the income (the amount by which the stock's fair market value on exercise of the option exceeds the option price: the "spread") will be taxed at ordinary income rates and a portion (any excess over the first amount) at capital gain rates. (There is rarely any portion exceeding the first amount, so usually all of the income is ordinary income upon a disqualifying disposition.)

Many ISOs end up losing their capital gain treatment in practice, because at the time of an initial public offering, merger, sale or other major corporate transaction resulting in liquidity of the corporation's stock, option holders will choose to exercise their options and simultaneously sell the underlying stock, thus receiving ordinary income treatment on the "spread." Even so, ISOs are an attractive choice because they do allow for the possibility of capital gains treatment.

NQSOs differ from ISOs for tax purposes in several ways. Generally, assuming compliance with the provisions of Internal Revenue Code Section 409A, the employee will have taxable income at the time of exercise of the options to the extent of the difference between the fair market value of the underlying stock and the exercise price.

Section 409A effectively requires that the exercise price of NQSOs be at least equal to the fair market value of the underlying stock; otherwise, severe tax penalties may be suffered on the part of the employee. The regulations under Section 409A provide guidelines as to how a company should determine the fair market value of its stock for these purposes.

A stockholder will recognize gain or loss on the subsequent sale of stock acquired upon exercise of NQSOs in an amount equal to the difference between the selling price and the tax basis of the stock, which will include the price paid plus the amount included in the holder's income by reason of the exercise of the NQSOs. Provided the shares of

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stock are held as a capital asset, any gain or loss resulting from a subsequent sale will be capital gain.

In order to be treated as ISOs, options must meet various requirements of the Internal Revenue Code, including, among other things, that at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, the individual must be an employee of either the corporation or a parent or subsidiary corporation. NQSOs have no such requirements.

Code Section 409A and the regulations thereunder provide guidelines for how a company should go about valuing its stock for purposes of determining exercise prices for options. Section 409A provides that a value will be presumed to be fair market value in certain circumstances.

With respect to non-public companies, to qualify for the presumptions on fair market value, a value for common stock must be determined by "a reasonable application of a reasonable valuation method." Essentially, this is a facts and circumstances test, although the regulations provide that a valuation method will be presumed reasonable if either of the following two methods is consistently applied to compensatory equity awards:

- A valuation by an outside independent appraiser (an "Independent Appraisal") meeting requirements comparable to valuations for charitable donations that is performed within 12 months of the grant date (unless intervening events have triggered a change in value, in which case a new valuation should be obtained).
- A reasonable good-faith valuation of "illiquid stock of a start-up corporation" that is supported by a written report taking into account certain standard valuation factors (asset value, present value of future cash flow, market value of similar companies, and other relevant factors) (an "Internal Valuation Report"). The persons performing these valuations must have "significant knowledge and experience or training in performing similar valuations."

Either an Independent Appraisal or an Internal Valuation Report should be obtained or provided to the Board of Directors at the time of grant of stock options. Such reports should be updated at least annually, depending upon the frequency of equity grants and depending upon internal or external events which could affect the value of a company's common stock.

Stock options can provide valuable incentives for employees. Understanding the requirements, the different choices, and their effects will help you decide what is right for you.

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