Many employees receive stock options as part of their compensation packages. From a tax standpoint, there are two kinds of options—statutory and nonstatutory. “Incentive stock options,” or ISOs, as they are commonly known, are statutory options, because they are specifically provided for in the Internal Revenue Code and are subject to numerous qualification requirements. Options that don't meet these requirements are nonstatutory stock options or NSOs (also known as nonqualified stock options or NQSOs).

Both kinds of options have tax advantages, but there are quite a few differences between them.

Option grant: If you have ISOs, you are *not* taxed on option grant. The same is generally true of NSOs. An NSO is taxed at grant only if it has a “readily ascertainable” fair market value (FMV), which is seldom the case. IRS rules say that an option doesn't have a readily ascertainable value at grant unless: (1) the option is actively traded or (2) (i) the option is immediately transferable; (ii) the option is fully exercisable; (iii) the option *and* the option stock are unrestricted; and (iv) the value of the “option privilege” is readily ascertainable. In the unlikely event that an NSO is taxable at grant, you have compensation income at that point.

The deferred compensation rules under Code Sec. 409A—which tax deferred compensation to the extent not subject to a “substantial risk of forfeiture” unless specific requirements are met—don't apply to the grant of an ISO. However, these rules can apply to the grant of an NSO, unless the exercise price can never be less than the underlying stock's FMV on the date the option is granted and certain other conditions are met.

Option exercise: No regular income tax is owed on the exercise of an ISO, but the alternative minimum tax (AMT) may apply. The bargain purchase element at exercise, which is the difference between the value of the ISO stock (i.e., stock acquired through the exercise of an ISO) at exercise and the lower price you pay for it, is considered to be income when figuring your AMT. Even if you're usually not subject to the AMT, exercising ISOs may push you into its range. (If you are subject to the AMT in the year you exercise ISOs, then you may be entitled to an AMT credit carryover for use against your regular income tax in some later year when you're not subject to the AMT.)

Any remuneration that arises when stock is transferred on the exercise of an ISO isn't subject to FICA or FUTA taxation.

When you exercise an NSO that wasn't taxed at grant, you're taxed at ordinary income rates on the difference between the value of the option stock at that time and the price you paid for it (plus any price you may have paid for the option, although generally that will be zero). This is compensation income that is subject to payroll taxes and income tax withholding. Taxes may be withheld from your salary or other compensation income, or you may have to sell some of the stock to cover the withholding or make some other arrangement with your employer.

However, if the option stock is nontransferable or subject to a substantial risk of forfeiture, then you aren't charged with compensation income until those restrictions no longer exist. In that case, you can choose to pay tax on exercise so that all gain from that point on would be capital gain.

Sale of option stock: When you sell ISO stock, you generally are taxed at favorable long-term capital gain rates on the difference between the price you paid for the stock and the amount you realize on its sale. However, if you sell the stock within two years of the option grant or within one year of the option exercise, you're hit with compensation income to the extent of your bargain element at exercise. The balance of your gain is capital gain, which will be taxed at favorable rates if you've held the stock for more than one year on the sale date.

It's important to know how long you need to hold the stock to qualify for long-term capital gain rates on the difference between the price you paid for the stock and the amount you realize on its sale or, if you don't hold the stock long enough for this favorable tax treatment, how much additional compensation income will be attributed to you. This can be determined from information on a statement from your employer. You should have received this statement by Jan. 31 following the close of the year in which you exercised the ISO.

If the option was exercised after Oct. 22, 2004, any income on disposition of the stock isn't subject to FICA or FUTA taxation. Additionally, any income resulting from a disqualifying disposition of stock acquired under an ISO isn't subject to withholding.

When you sell stock acquired by exercise of an NSO, you have capital gain if you were subject to tax either at option grant or exercise, or when restrictions on your option stock lapsed. Otherwise, you have compensation income at the time of the sale.

Gifts of options: Some people would like to give stock options to family members as part of their overall estate planning. Transferring property before it increases in value helps lower or eliminate estate and gift taxes.

This can't be done with ISOs, because they can't be transferred during the optionee's lifetime and can't be exercised by anyone but the optionee during his or her life.

NSOs have an edge here if the option plan allows options to be transferred to family members, as many plans now do. However, the IRS has ruled that an option transfer isn't complete for gift tax purposes until the option is no longer conditioned on the performance of future services. That usually means that the gift will be subject to gift tax at a time when the option's value has increased.

The IRS also has issued some complicated rules for valuing gifts of NSOs. For income tax purposes, a gift of NSOs to a family member isn't a disposition that triggers tax. Instead, the employee will be taxed when the transferee exercises the options.