

Refresher on Incentive Stock Options

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Incentive stock options (“**ISOs**”) are a form of equity compensation that allows employees to purchase shares of their employer’s stock at an exercise price set on the grant date, with potentially favorable employee tax treatment. Specifically, on exercise, an employee can avoid ordinary income taxation (although the spread on exercise may be subject to the alternative minimum tax for high-income earners), provided that the ISO meets strict requirements, as summarized below.

- **Eligible ISO Recipients:** ISOs can only be granted to employees of corporations. Options granted to non-employee directors or contractors or to employees of partnerships or limited liability companies are nonqualified stock options (“**NQSOs**”).
- **Plan and Stockholder Approval:** ISOs must be granted under an equity plan that is approved by stockholders within 12 months before or after the date the plan is adopted by the employer’s board of directors.
- **Agreement Must Reflect ISO Status at Grant:** The award agreement granting the ISO must state that the option is intended to be an ISO. An employer cannot later designate an option as an ISO—the award must be treated as an ISO from the date of grant.
- **Holding Period Requirement:** The employee must hold the stock for at least two years after the grant date and one year after the exercise date. If either period is not met, a “disqualifying disposition” occurs and the employee recognizes ordinary income tax on the spread between the exercise price and the stock’s fair market value as of the exercise date. For example, selling shares immediately following exercise of the stock option in connection with a company sale or other transaction results in a disqualifying disposition. A disqualifying disposition also occurs if an employer uses a net settlement of shares to cover the employee’s aggregate exercise price.
- **Term and Exercise Period:** An ISO may not have a term exceeding 10 years (or five years for an employee who owns more than 10% of the total combined voting power of all classes of stock of the employer). An ISO generally remains exercisable for up to three months following the employee’s termination of service (other than for death or disability) and for one year following death or disability.
- **Annual Limit:** The aggregate fair market value of the stock (determined at the time of grant) that first becomes exercisable by an employee in any calendar year may not exceed \$100,000. Any excess is treated as an NQSO.
- **Fair Market Value at Grant:** ISOs and NQSOs must be granted at fair market value on the date of grant, subject to exceptions as we previously reported [here](#). For an employee who owns more than 10% of the total combined voting power of all classes of stock of the employer (or its parent or subsidiary), the exercise price of an ISO must be at least 110% of fair market value on the date of grant.

- **Employer Loss of Compensation Deduction:** Employers generally cannot take a compensation deduction upon exercise of an ISO because the employee does not pay ordinary income tax. If the employee makes a disqualifying disposition at exercise, however, the employer may be entitled to a corresponding compensation deduction.

ISOs can sound like an attractive form of compensation, for the reasons outlined above. However, prior to granting ISOs, employers should carefully consider whether granting ISOs is worth the added complexity and administrative burdens. For example, if employees won't exercise options until an exit event, they will never realize the favorable tax treatment and it would be simpler to grant NQSOs. Prior to granting ISOs, employers should work with their outside counsel to decide whether ISOs are the right fit for the employer's compensation goals.