

**DIFFERENCES BETWEEN STOCK OPTION PLANS**

	<b><u>Incentive Stock Options (“ISOs”)</u></b>	<b><u>Nonstatutory Stock Options (“NSOs”)</u></b>
To whom may options be granted?	Only to employees.	To employees, independent contractors, non-employee directors and others.
What are the tax requirements under the Code?	<p>(1) The Plan must be contained in a written document that adequately establishes its terms.</p> <p>(2) The Plan must designate the maximum aggregate number of shares that may be issued under the Plan through ISOs.</p> <p>(3) The Plan must specify the employees or classes of employees who may benefit under the Plan.</p> <p>(4) The Plan must be approved by the stockholders of the corporation within twelve (12) months before or after the Plan has been adopted.</p> <p>(5) The Plan cannot have a duration that exceeds ten (10) years from the earlier of the date of the Plan is adopted or the date the Plan is approved by the stockholders.</p> <p>(6) The Option Agreement must be writing.</p> <p>(7) The Option Agreement must provide that the option cannot be exercised more than ten (10) years (five (5) years in the case of a 10% owner) after the date in which the option was granted.</p> <p>(8) The Option Agreement must provide that the option cannot be transferred other than by will or by the laws of descent and distribution.</p> <p>(9) The exercise price must not be less than 100% of the FMV of the stock on the date the option is granted. For 10% owners, the exercise price must be at least equal to 110% of the FMV of the stock on the dates of grant.</p> <p>(10) The Optionee must be an employee of the corporation at all times during the term of the ISO, except for a period of three (3) months immediately following the optionee’s termination of employment.</p> <p>(11) Options are treated as ISOs to the extent that the aggregate FMV of the stock with respect to which ISOs are exercisable by the optionee for the first time during any calendar year does not exceed</p>	<p>There are limited legal requirements for NSOs. However, the Plan must be in writing and a valuation needs to be performed to assure that stock options are issued at FMV. Otherwise, discounted options would be deemed deferred compensation subject to Code § 409A and the employee will face significant adverse tax consequences.</p>

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	\$100,000. Those options in excess of \$100,000 are treated as NSOs, not ISOs.	
Are options taxable at time of grant?	No, regardless of whether any portion of ISO is unrestricted or not subject to a substantial risk of forfeiture (“vested”).	No, as long as the option does not have a “readily ascertainable fair market value (“FMV”)” at the time of grant. Typically, only options that are separately traded on established markets have a readily ascertainable FMV and are subject to tax when received.
Are options taxable upon exercise?	Under Code § 421, there is no regular income tax consequence; however, if stock is not sold before the calendar year in which the exercise occurred, the exclusion from income is ignored in computing alternative minimum taxable income (“AMTI”). The amount by which the FMV of the stock received upon exercise exceeds the exercise price is a tax preference adjustment for purposes of the AMTI calculation, when the stock acquired is vested.	Yes, the difference between the exercise price of a NSO and FMV of the stock received upon exercise will be recognized as ordinary income as long as the option stock is vested. However, if the option stock is not vested, the option is not taxable upon exercise but upon vesting, unless a timely Code § 83(b) election is made.
Can a Code § 83(b) election be made and, if so, what effect will it have?	A Code § 83(b) election allows an employee to elect to currently include in income the FMV of the stock, less any amount paid for it, at the time stock is issued even though not substantially vested. The election is not available if the stock is already vested. When an ISO is exercised, if the stock is not vested, a § 83(b) election can be made. A § 83(b) election upon the exercise of ISOs may only apply for AMTI purposes. Therefore, the employee can elect to include in AMTI the excess of the unvested stock’s FMV over the exercise price.	An 83(b) election can be made at exercise in the event that the NSO stock is not vested. Thus, the 83(b) election gives the employee the opportunity to limit their ordinary income at the time of exercise, as opposed to the time when the restrictions and forfeiture conditions lapse and the stock vests. Any appreciation in the property after a § 83(b) election has been made is converted into potential CG income.
How are options taxed at the time of disposition?	If the employee disposes of ISO stock after completion of the “statutory holding period” ( <i>i.e.</i> , the stock is held more than two (2) years after the date the option was granted or more than one (1) year after the date the option was exercised), the employee will recognize the difference between the amount received upon sale over the employee’s basis in the ISO stock as long term capital gain (“LTCCG”). If stock is disposed of before the end of the statutory holding period, the “disqualifying disposition” would cause the employee to recognize the difference between the ISO’s exercise	If the employee disposes of NSO stock, all gain on the sale will be subject to CG treatment calculated as the difference between the sales price and the basis ( <i>i.e.</i> , the sum of exercise price and the income recognized upon exercise).

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	price and the ISO stock’s FMV at the time of exercise as ordinary income. This ordinary income will be added to the ISO stock’s basis to determine the amount of capital gain (“CG”) that will be recognized on the disqualifying disposition. The CG can be long-term or short-term depending how long the stock is held.	
What are the tax consequences to the employer?	The employer will not be entitled to a compensation deduction on account of an employee’s exercise of an ISO, unless there is a subsequent disqualifying disposition. If the employee recognizes ordinary income on the sale of the shares acquired upon the exercise due to the disqualifying disposition, the employer will be entitled to take a deduction equal to the amount recognized by the employee as ordinary income.	The employer will be entitled to a compensation deduction for its taxable year with or within which the employee recognizes ordinary income upon exercise of a NSO.
What are the withholding obligations of the employer?	Income on the transfer of stock pursuant to an exercise of ISOs or any disposition (even a disqualifying disposition) is not subject to FICA, FUTA or federal income tax withholding.	When the employee recognizes ordinary income from the exercise of a NSO, income is subject to FICA, FUTA and federal income tax withholding.
What reporting obligations does the employer have?	The employer transferring stock pursuant to an individual’s exercise of an ISO must file a Form 3921, and a copy must be given to each affected employee. The W-2 Form also needs to reflect ordinary income upon a disqualifying disposition of stock acquired pursuant to the exercise of the ISO.	Since the employee has income on the exercise of the NSO, the employer must report the income on the employee’s W-2 Form. If outside directors, consultants and other non-employers, income is reported on Form 1099-Misc.
How are options taxed under Pennsylvania law?	Pennsylvania taxes ISOs in the same manner as NSOs. Thus, the employee is taxed on the difference between the exercise price of the ISO and the FMV of the stock received upon exercise as compensation income. The employer is entitled to a state income tax deduction in the amount of the compensation income recognized by the employee upon the exercise of ISOs.	Same rules apply to NSOs.
What are Pennsylvania state withholding obligations of the employer?	Employers are required to withhold Pennsylvania income taxes from compensation income recognized upon exercise of the ISO.	Same rules apply to NSOs.

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What requirements are there to register securities under federal and Pennsylvania law?	<p>(1) Under Rule 701 of the Securities Act of 1933, a private company may offer its own securities as part of written compensation agreements to employees, directors, general partners, trustees, officers and consultants without having to comply with federal securities registration requirements, as long as total sales (not offerings) of stock during a twelve (12) month period do not exceed the greater of:</p> <ul style="list-style-type: none"> <li>(a) \$1 million;</li> <li>(b) 15% of the issuers total assets; or</li> <li>(c) 15% of all the outstanding securities of that class.</li> </ul> <p>All optionees and shareholders must be provided with a copy of the plan under which the options are granted.</p> <p>(2) Pennsylvania law exempts from registration securities issued in good faith reliance that the transaction qualifies for the SEC Rule 701 exemption.</p>	Same rules apply to NSOs.

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