

## Founder Fundamentals

### Stock Options and Valuations: Tax Focus

By Pamela A. Grinter

Stock options can provide a much-needed component of compensation for startup employees. Different types of equity compensation have different tax consequences with costs and benefits to the company and its employees.

This article discusses the tax consequences of Restricted Stock (RS), Incentive Stock Options (ISO) and Nonqualified stock options (NQO). In addition to the tax consequences for employees, there are tax and accounting implications for the company. You should consult your accountant or tax adviser for specific accounting and tax implications, but very generally, when the employee recognizes ordinary compensation income, the company will have a deduction for compensation income, and a charge to accounting income as well.

#### Stock Options

A startup may choose to offer an employee or independent contractor the right to purchase stock in the company as a part of the service provider's total compensation package. Stock options have the benefit of aligning the employee with the success of the company.

A stock option is the right to purchase a certain number of shares of stock in the company for a stated price, called the exercise price or strike price. For an issued option, the exercise price will not change over time. The option increases in value as the price per share of the underlying stock rises. The difference between the exercise price for a share of stock and its fair market value (FMV) is called the spread. There are two types of stock options: Nonqualified Stock Options and Incentive Stock Options. Each carries different tax consequences. A company may also issue restricted stock, which is treated differently still for tax purposes.

#### Nonqualified Stock Options

Nonqualified Stock Options can be offered to employees or independent contractors as compensation for services. Since the NQO does not have a readily ascertainable fair market value (i.e. it is not traded on a market), the recipient does not recognize gain or loss on the date the option is granted. When the option holder exercises the NQO, she will have a taxable gain on the difference between the fair market value of the stock on that date and the exercise price paid for the stock. This amount will be taxed as compensation income (and subject to withholding) and will generate a compensation deduction for the employer.

Stock acquired by the exercise of an NQO will be treated as any other investment property when sold. The holder's basis is the amount paid for the stock, plus any amount included in income upon exercise of the option. The holding period (for purposes of the application of the long-term capital gains rules) begins on the date the option was exercised.

#### Incentive Stock Options

An Incentive Stock Option is an option to purchase corporate stock, with certain specific requirements. If the ISO requirements are met, the option holder does not recognize a taxable gain or loss on the grant of the option or upon exercise of the option. Instead, the option holder will recognize gain or loss when the shares acquired upon exercise of the option are sold.

Gain or loss from the sale of stock acquired upon exercise of an ISO is capital gain or loss if the option holder owns the stock for at least two years after the option is granted and for at least one year after the option is exercised. The gain or loss is the difference between the exercise price and the amount received on the sale of the stock. The option holder must be an employee of the corporation from the time the option is granted until three months before the options are exercised.

If the option holder has not owned the stock for at least two years after the option is granted and for at least one year after the option is exercised, gain on the sale is ordinary income equal to the fair market value of the stock when the option was exercised, less the exercise price. Any excess gain capital gain and any loss is a capital loss.

ISOs must be issued with an exercise price equal to the fair market value of the underlying stock on the date of grant and only \$100,000 of value (at the time of grant) can be exercised in any one year. ISOs must be issued under a plan adopted by the granting corporation, which must meet a variety of requirements.

### Restricted Stock

Restricted stock is stock of a company that is not fully transferable until certain conditions have been met. Typical conditions include meeting certain performance goals or continuing as an employee of the company over a continuous time period. Upon satisfaction of the conditions, the stock is no longer restricted, which is also referred to as vested, and becomes transferable by the holder.

The fair market value of RS is included in income on the date of grant, unless the stock is subject to “substantial risk of forfeiture,” in other words, subject to vesting requirements. If there is an exercise price for the RS, the income is the difference between the fair market value and the exercise price. If the stock is subject to substantial risk of forfeiture (i.e., is subject to vesting over time or based on performance), the fair market value of the RS is included in income in the year in which the risk of forfeiture lapses (i.e., as vesting occurs).

A service provider who receives RS that is not yet vested can elect, under Code Section 83(b), to include the fair market value of the RS into income in

the year the property is received. This is compensation (ordinary) income when the RS is received for services. This election may make sense if the RS is likely to increase in value over time.

If the RS is forfeit after the election is made and before it is substantially vested, the forfeiture is treated as a sale or exchange on which a loss is realized, equal to any excess of the amount paid for the RS minus any amount realized upon the forfeiture. Gain on the later sale of the RS is capital gain.

### Company Valuation

Options should be granted with an exercise price equal to or in excess of the FMV of the stock on the date of grant, so valuation is critical. The regulations under Internal Revenue Code Section 409A provide several safe harbors for a company determining the value of its common stock. One is an independent appraisal, frequently called a 409A valuation. If one of the three safe harbors is met, the valuation should be valid for one year, absent any material changes in the company or its business.

There are substantial penalties for a failure to comply with Code Section 409A.

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