

Acredula

BRICKER & ECKLER LLP

100 South Third Street
Columbus, Ohio 43215-4291
(614) 227-2300
FAX (614) 227-2390

info@bricker.com
www.bricker.com
www.BoardandExecutive.net

Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

We invite you to photocopy and distribute this newsletter as you wish. Or, request additional copies from us.

Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Stock Options Play an Important Role in Executives' Compensation

Stock options have long been a component of executives' compensation. Prior to the stock markets' recent rise, institutional and other long-term financial investors encouraged the use of stock options because they not only aligned the interests of management and stockholders, but also did not involve a cash outlay by the employer.

Despite the common misperceptions that stock options can only be used to purchase employer stock and that they are not available to closely held corporations or non-stock organizations, tax-exempt organizations and other non-stock companies have granted options in mutual funds and other securities to their executives. Through these options, executives of non-stock companies can enjoy benefits similar to those of executives receiving employer stock options. Unlike other forms of compensation, the executive controls when he or she is taxed on the options (for non-qualified stock options, the executive is taxed when the option is exercised, and for incentive stock options, the executive is taxed when the purchased stock is sold).

Traditionally, stock options accounted for less than 20 percent of an executive's compensation. Today, options account

Editor's Note

for up to 50 percent of an executive's compensation in traditional companies, and up to 75 or 80 percent of an executive's compensation in e-commerce companies. Institutional and other financial investors are concerned that the total amount of executives' compensation, including stock options, has become unreasonable. These investors are further afraid that stock options are giving executives the opportunity to retire or quit rather than encouraging them to continue to work toward the improvement of stockholder value.

Despite these concerns, stock options are likely to remain a significant component of executives' compensation. This month's article focuses on the features of qualified and non-qualified stock options, highlighting the greater flexibility of non-qualified stock options over incentive stock options.



John P. Beavers
Partner,
Bricker & Eckler LLP

Non-Qualified Stock Options Offer Greater Flexibility Than Qualified Stock Options

Stock options have become a significant component of executives' compensation in every industry. Since the 1990s, as much as 75 percent of the compensation given to executives in e-commerce and technology companies has been derived from stock options. Even executives of non-profit and other non-stock organizations are now participating in non-employer stock options to purchase mutual fund shares and similar securities.

Several stock options are available to employers and executives, including qualified stock options and non-qualified stock options. If certain requirements are met under applicable tax laws, there is no federal income tax consequence to a qualified stock option until sale or disposition of the stock acquired upon exercise of the option. Today, there are two forms of qualified stock options that receive such favorable treatment: incentive stock options and options granted under employee stock purchase plans. Options that do not meet the requirements for favorable tax treatment are known as non-qualified stock options. Non-qualified stock options are governed by the same tax laws governing transfers of property to employees and others in connection with their performance of service.

Incentive stock options have received much attention because of their favorable tax attributes to employees. Unless there is a disqualifying disposition or an exercise in excess of the \$100,000 limitation, incentive stock options are not taxable until sale or other disposition of the stock acquired upon exercise of the option. In other words, there is no tax event upon granting or exercising of the option. If properly exercised, the spread between the market value and the option price of the securities acquired is taxable to the optionee as a sale of property at capital gains rates rather than as compensation at ordinary income rates.

However, non-qualified stock options are used extensively as a component of executives' compensation. Because they offer greater flexibility than incentive stock options, non-qualified stock options can be designed to accommodate every need of the employer and the executive. Non-qualified stock options are not limited to employer stock, but may be granted for the purchase of mutual fund shares and other securities. Non-qualified stock options also allow the employer to deduct as an ordinary and necessary business expense the amount includible in the optionee's gross income.

With so many differences between qualified and non-qualified stock options, employers may have a hard time determining which option to offer to their executives. For this reason, this article compares the features of each stock option.

Qualified Versus Non-Qualified Stock Options

Type of Securities

Incentive stock options must be used for the purchase of the employer's stock, or the stock of a parent or subsidiary of the employer. *Non-qualified stock options* may be used for the purchase of any security, whether or not of the employer, including mutual fund shares and indices.

Adoption

Incentive stock options must be granted pursuant to a "plan" that is approved by stockholders within 12 months before or after the date the plan is adopted by the employer (typically by its governing board). The plan must set forth the aggregate number of shares subject to the plan and the class of employee eligible to participate. *Non-qualified stock options* do not require stockholder approval, but typically require authorization by the employer's governing board.

Aggregate number or amount of securities

Incentive stock option plans must set forth the aggregate number of shares that may be issued upon exercise of options under the plan. *Non-qualified stock option* plans do not have a limit on the aggregate number or amount of shares or other securities that may be issued upon exercise of options under the plan.

Class of eligible employees

Incentive stock option plans must also set forth the class of employees eligible to receive options under the plan. *Incentive stock option* plans are generally limited to persons who are employees at the date of grant. *Non-qualified stock option* plans do not have a requirement limiting eligibility to a defined class of employees. See also "Optionee eligibility" and "Employment condition."



John P. Beavers
Partner,
Bricker & Eckler LLP

Duration of the plan

Incentive stock options may only be issued for a period of 10 years from either the date of adoption or the date of the plan's approval by stockholders, whichever comes first. *Non-qualified stock options* have no limit on the period during which they may be granted.

Exercise price

Incentive stock options' exercise price, sometimes referred to as the "exercise" or "option" price, cannot be less than the stock's fair market value at the date of grant. *Non-qualified stock options* have no limit on their exercise or option price. When the exercise price reflects a "discount" from the market price, it is generally referred to as a "discounted option." Discounted options are often as much as 75 percent of the market price. In addition, the exercise price may "float" with the market price, which means that it will be a percentage of the market price at the date of exercise rather than at the date of grant.

Exercise period

Incentive stock options may be exercisable immediately upon the date of grant, or may be deferred for a period or subject to a vesting schedule, subject to an expiration date. *Non-qualified stock options* may be exercisable immediately upon the date of grant, or may be deferred for a period or subject to a vesting schedule. There is no required expiration date. With respect to discounted options, a waiting period of up to one or two years is often imposed to assure that there is an element of risk involved so that the options are treated as an option rather than an immediate transfer of property under the tax laws.

Option expiration date

Incentive stock options must expire upon the tenth anniversary of their date of grant (or the fifth anniversary to fall within the exception for optionees who are more than 10 percent stockholders). See also "Optionee eligibility, limit on stock ownership." *Non-qualified stock options* are not required to expire on any particular date. The Internal Revenue Service has not formally ruled that options with a term longer than 15 years constitute an option as opposed to some other form of property right.

Optionee eligibility, service relationship

Incentive stock options require optionees to be an "employee" receiving compensation subject to the rules for withholding tax from wages at the date of grant. Directors who are not employees and independent contractors are not eligible. For

non-qualified stock options, optionees need not be employees receiving compensation subject to withholding, but must be providing services to the employer or a parent or subsidiary of the employer. As a result, directors and independent contractors may be eligible for non-qualified options.

Optionee eligibility, limit on stock ownership

For *incentive stock options* to be qualified, the optionee may not own stock possessing more than 10 percent of the total voting power of all classes of the employer's stock at the date of grant. However, the stock ownership limitation will not apply if the option price is at least 110 percent of the stock's fair market value subject to the options at the date of grant, and the options by their terms are not exercisable more than five years from the date it is granted.

Unless *non-qualified stock options* have a readily ascertainable market value at the date of grant, they are not taxable until exercised. At that time, the spread between the market value and the option price of the securities acquired is taxable to the optionee as compensation at ordinary income tax rates. In addition, the spread is treated as wages subject to employment taxes, including Social Security, Medicare, and unemployment taxes. The employer is required to report the spread, withholding is required at the source, and the employer is subject to its employer share of Social Security, Medicare, and unemployment taxes.

Disqualifying dispositions

For *incentive stock options* to receive favorable tax treatment, optionees may not make any sale or other disposition of the stock acquired upon exercise of the stock options within two years from the option's date of grant or one year from its date of exercise, except that the holding period does not limit a sale or other disposition of the stock if the options are exercised after the optionee's death. *Non-qualified stock options* are not subject to any such limitation on how long the stock must be held before sale or disposition.

Because they offer greater flexibility than incentive stock options, non-qualified stock options can be designed to accommodate every need of the employer and the executive.

\$100,000 limitation

Favorable tax treatment of *incentive stock options* is limited to the first \$100,000 of the stock's aggregate fair market value (determined at the option's time of grant) subject to options that first become exercisable in any calendar year. Options exercised in excess of this \$100,000 limitation are treated as *non-qualified stock options*. *Non-qualified stock options* are not subject to any such limit on the fair market value that may become exercisable or exercised during any calendar year.

Employment condition

For *incentive stock options* to receive favorable tax treatment, the optionee must be an employee, or have been an employee three months before the option's date of exercise. For persons who became disabled, the three-month period may be extended to one year. *Non-qualified stock options* are not subject to any such requirement for continued employment or service of the optionee.

Taxation to optionee

If *incentive stock options* are properly exercised within the employment condition and there is no disqualifying disposition or violation of the \$100,000 limit, there is no tax event until the stock acquired upon exercise of the options is sold or otherwise disposed. Then, the spread between the market value and the option price of the securities acquired is taxable to the optionee as a sale of property at capital gains rates. The exercise of *non-qualified stock options* triggers a tax event. The spread between the market value and the option price of the securities acquired is taxable to the optionee as compensation at ordinary

income tax rates. In addition, the spread is treated as wages subject to employment taxes, including Social Security, Medicare, and unemployment taxes.

Employer deduction

Properly granted and exercised *incentive stock options* do not result in any deduction by the employer; however, the employer is entitled to deduct as an ordinary and necessary business expense any amount includible in the optionee's gross income to the extent that the options are subject to taxation as *non-qualified stock options*. With respect to *non-qualified stock options*, the employer is entitled to deduct the amount includible in the optionee's gross income for the taxable year that includes the calendar year for which the optionee is required to include the amount in his or her income.

Conclusion

From these comparisons, it is easy to see that non-qualified stock options offer greater flexibility than qualified stock options. For-profit and non-profit organizations alike are providing stock options in their executives' compensation packages. Many are finding that non-qualified stock options offer executives several advantages, including control of when they are taxed on the options and the opportunity to diversify their investments. In addition, employers will benefit from non-qualified stock options as they may deduct as an ordinary and necessary business expense the amount includible in the employee's gross income. Knowing the advantages and disadvantages of both kinds of stock can help any business or executive determine the merits of their compensation packages.

Counsel for BOARDS AND EXECUTIVES

A Bricker & Eckler Initiative

John P. Beavers, Chair
(614) 227-2361
jbeavers@bricker.com

Jerry O. Allen
(614) 227-8834
jallen@bricker.com

Laurie A. Briggs
(614) 227-2355
lbriggs@bricker.com

Thomas R. Brownlee, Jr.
(614) 227-2301
bbrownlee@bricker.com

John W. Cook, III
(614) 227-2383
jcook@bricker.com

Michael E. Flowers
(614) 227-2340
mflowers@bricker.com

James F. Flynn
(614) 227-8855
jflynn@bricker.com

Michael K. Gire
(614) 227-2318
mgire@bricker.com

Hope M. Goings
(614) 227-2360
hgoings@bricker.com

Steven R. Kerber
(614) 227-2356
skerber@bricker.com

Quintin F. Lindsmith
(614) 227-8802
qlindsmith@bricker.com

Gordon F. Litt
(614) 227-2305
glitt@bricker.com

Mark C. Pomeroy
(614) 227-2326
mpomeroy@bricker.com

Christine M. Poth
(614) 227-2395
cpoth@bricker.com

Richard D. Rogovin
(614) 227-2352
rrogovin@bricker.com

James A. Rutledge
(614) 227-8830
jrutledge@bricker.com

David C. Spialter
(614) 227-2342
dspialter@bricker.com

Michael F. Sullivan
(614) 227-2337
msullivan@bricker.com

Betsy A. Swift
(614) 227-8850
bswift@bricker.com

Kurtis A. Tunnell
(614) 227-8837
ktunnell@bricker.com

Faith M. Williams
(614) 227-2374
fwilliams@bricker.com

Randolph C. Wiseman
(614) 227-2310
rwiseman@bricker.com