Considerations for Awarding Incentive Stock Options

December 23, 2024 – Cross-Border Counselor
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Canadian companies that award stock options to their employees, non-employee directors and/or other service providers often inquire as to whether they should offer Incentive Stock Options ("ISOs") to any such individuals who are U.S. taxpayers. Below is a discussion of some of the tax considerations in awarding ISOs and the main requirements that must be met for an option to qualify as an ISO.

Please note, this blog post provides only a high-level summary of the tax treatment of options as well as some of the notable requirements for an option to qualify as an ISO. This article does not purport to cover every nuance or situation. As such, you should consult with U.S. counsel (as well as your accountants) for assistance in determining whether ISOs should be awarded, and if so, the requirements that must be met.

Tax Considerations in Awarding ISOs

Under U.S. tax law, an option will be treated as either (i) an Incentive Stock Option or (ii) a Nonqualified Stock Option ("NSO"). An option that does not meet the requirements for ISO treatment will be treated as an NSO for tax purposes.

An ISO allows the option holder the opportunity to obtain more favorable tax treatment in that (i) there is no tax due at exercise (as contrasted with NSOs where the spread is taxed at ordinary income rates at the time of exercise), and (ii) if ISO shares are held until the end or the required ISO holding period (i.e. held for at least one year after exercise and two years after grant), the excess of the sales price over the exercise price will be taxed at the long-term capital gains rate. This means that the amount of the spread at the time of exercise is never taxed at the higher ordinary income rates and no Federal Insurance Contributions Act ("FICA") taxes (i.e. Social Security and Medicare taxes) are paid. While there is the potential for more favorable tax treatment for the option holder, depending on the individual's specific tax circumstances, the exercise of an ISO could trigger something known as alternative minimum tax, so the option holder

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may not actually get the full tax benefit.

On the other hand, ISOs are potentially less favorable to the employer because it will not be eligible to take a compensation expense deduction on its U.S. corporate income tax return for the compensatory element of the ISO (i.e. the amount of the spread at the time of exercise), unless the employee makes a disqualifying disposition (i.e. sells before the end of the required ISO holding period). In contrast, the employer may take such deduction if the option is an NSO.

What are the Requirements for ISOs?

One of the main limitations of an ISO is that it may only be granted to employees of the issuing company (or a subsidiary). This means that non-employee directors and consultants are not eligible to receive ISOs. Moreover, while it is common in Canadian equity plans for the number of authorized shares to be represented as a rolling percentage, a plan that awards ISOs must designate a fixed number of shares authorized to be granted as ISOs. An ISO may not have a term of longer than ten years, and there is no explicit exception to this rule for an ISO that may expire during a blackout. For each optionee, no more than $100,000 in options may first become exercisable in any calendar year, and to the extent the $100,000 limit is exceeded, the excess is treated as an NSO. Lastly, it is important to note that in order to grant ISOs, the plan must be approved by the shareholders of the issuing company within 12 months of adoption of the plan.

Concluding Considerations

It is worth reiterating that should an option designated as an ISO fail to meet any of the ISO requirements, the option will be treated as an NSO for tax purposes. As such, an option holder would be in no worse of a position than if the option had been originally designated as an NSO. For this reason, as long as shareholder approval is not expected to be an obstacle, many companies ultimately decide to award ISOs to employees that are U.S. taxpayers. In particular, companies that award options to lower-to-mid level paid employees may wish to consider ISOs, as these employees are not typically subject to the alternative minimum tax and would not likely exceed the $100,000 limit on ISOs.