

The Founder's Guide to Equity Compensation: Stock Options

February 25, 2025



Written by: Marlen Preyger and Berenice Curet

Equity compensation is an integral component of the Tech start-up compensation model. Attracting and retaining top talent is crucial for the growth, survival, and prolonged success of any emerging company, driving the necessity in offering competitive compensation. Most early-stage companies don't generate the cash flow necessary to offer or maintain these packages in the form of cash while effectively growing the business, making it challenging for founders to build a strong team. For this reason, equity incentives are typically weaved into compensation packages in addition to cash. Offering equity affords companies greater cash runway, while also attracting the right people to drive growth by allowing the recipient the opportunity to be fully invested in the future upside of the business.

While there are several forms of equity compensation, stock options are a commonly used incentive in the start-up world. Options grant recipients the future right to buy shares of the company's stock (usually common stock) at a pre-set purchase price, known as the exercise or strike price. They're typically granted to a mix of employees, contractors, advisors and consultants, subject to various rules depending on the type of stock option granted. The recipient usually vests in the right to exercise their options in exchange for service provided (*i.e.*, employment) over a 2 to

4-year period, however vesting may also be contingent upon achieving various performance criteria such as hitting sales targets or achieving major milestones.

There are two types of stock options: Nonqualified Stock Options (NSOs) and Incentive Stock Options (ISOs). Although mechanically NSOs and ISOs are similar, be aware that each have very different rules and benefits for both the granting entity and the grantees.

	Incentive Stock Options (ISO)	Non-Qualified Stock Option (NSO)
Eligible Recipients	Employees only	Employees, advisors, contractors, or service providers.
Grantee Tax Implications on Grant Date	No taxable event upon grant	No taxable event upon grant
Grantee Tax Implications on Exercise Date	Typically, no taxable event upon exercising, however; may trigger Alternative Minimum Tax (AMT) if the spread between the exercise price and the fair market value (FMV) of the stock on the exercise date is significant.	Grantee recognizes ordinary income / compensation for the value of the spread between the exercise price and the FMV of stock on exercise date.
Grantee Tax Implications Upon Sale of Stock	Sales Price less Exercise Price = Long Term Capital Gain (LTCG)	Sales Price less FMV of stock from exercise = Long Term Capital Gain

	Incentive Stock Options (ISO)	Non-Qualified Stock Option (NSO)
Granting Entity Tax Deductions	Sales Price less FMV of stock from exercise = Long Term Capital Gain	Entity receives tax deduction equal to the compensation recognized by grantee upon exercising.
Granting Entity Compliance Requirements	Granting entities must file Form 3921 to report the ISO exercise.	Granting entities report exercises by employees on their W-2's, and are required to withhold relevant payroll taxes. Exercises by all other recipients are reported on Form 1099-NEC.
Holding Period Rules for LTCG Treatment	Grantee must hold stock for more than 1 year after exercise AND more than 2 years after grant.	Must hold stock for more than 1 year
Value Restrictions	A max value of \$100,000 may become exercisable in any one calendar year per grantee. Any amount in excess is treated as an NSO.	No restrictions on amount that can be granted.

The above summary lists many of the main differences between both types of options, however there are more points to consider, making it crucial to speak with your tax advisor to [fully understand and plan your unique situation](#). One rule frequently violated is the stock holding period requirement related to ISOs. While they offer the grantee significant tax benefits, the grantee is at risk of laying out their cash to exercise an ISO and the underlying stock depreciating in value should the company not be successful. Accordingly, many founders and employees don't

exercise their ISOs until there's an opportunity to sell the underlying stock, typically in contemplation of an upcoming secondary opportunity or exit. In these situations, the required holding period after exercising the ISO is likely not met, triggering a disqualified disposition and related NSO compensation rules.

It is critical for founders to understand these nuances in order to build the right team and attract the best talent, negotiate compensation packages for themselves as they successfully grow their companies, and plan the timing of ISO exercises ahead of potential secondary or exit opportunities.

For more information on stock options and how they can be leveraged for your needs, please contact [Chris Noble](#) - Partner and Co-Leader of the Technology Group, [Adam Pizzo](#) - Partner and Co-Leader of the Technology Group, or your Anchin Relationship Partner.