Nonqualified Stock Options: An Overview
After reading this overview, see our NQSO content section for more detailed coverage.

NQSOs
Nonqualified stock options (commonly abbreviated NQSOs) are the most common type of option. Browse an overview of this section below, or explore the subtopics to the left. See also the NQSO sections of the Tax Center.

Test your knowledge with our NEW! NQSOs quiz and interactive answer key!

Test your knowledge with our Stock Options quiz and interactive answer key!

Listen to our podcast on the basics of stock options, or watch our videos on core concepts and taxes.

Selected Articles

**Stock Options 101: The Essentials**
Matt Simon

Podcast included! Your company has granted you stock options. Now what? This article explains the essential facts that you must know to understand your stock options and make the most of them.

**Stock Options Made Simple: Comparing NQSOs And ISOs**
Matt Simon

Stock options rose to fame in the 1990s. Even on the TV sitcom *Seinfeld*, Elaine got lucrative stock options and couldn't stop talking about them (provoking George's resentment, of course). Options remain a major form of employee equity. This article compares the
What is a nonqualified stock option?

- A nonqualified stock option, or NQSO, is a type of stock option that does not qualify for special favorable tax treatment under the US Internal Revenue Code.
- “Nonqualified" refers to the tax treatment.
- NQSOs are the most common form of stock option.
- They can be granted to employees, officers, directors, and consultants and other providers of goods and services.
How do NQSOs work?

- In general, a stock option is a stock-purchase right a company grants to an individual under the terms of a stock plan and grant agreement.
- You can exercise NQSOs to buy a specific number of shares of company stock at a set price during a specified period.
How do NQSOs work?

- NQSOs usually cannot be exercised until a vesting period has elapsed.
- NQSOs expire at the end of the term (e.g. ten years from the grant date) provided in the stock plan and grant agreement. After expiration, they cannot be exercised.
- Job termination almost always stops vesting and triggers post-termination exercise rules.
- Rules may vary in some situations, such as death, disability, or retirement, depending on the specifics of your plan and grant agreement.
After the vesting period has elapsed, you can exercise the NQSOs.

To generate income at exercise, the set exercise price of the NQSOs must be lower than the market price of the stock on the exercise date.

Exercise income is called the spread.

The spread is subject to income tax and Social Security/Medicare taxes.
How do NQSOs work?

- After acquiring company shares at exercise, you own them in the way of any other shareholder. You can sell, gift, pledge, or hold the shares.
- When you sell the shares, you pay capital gains tax on any appreciation over the stock’s value at exercise.
Typically, a vesting schedule is time-based: you must work at the company for a certain period before vesting.

The schedule can also (or instead) be performance-based or tied to company-specific or stock-market targets.

Vesting schedules provide for either "cliff" vesting (the whole grant vests after you complete a stated service period) or "graded" vesting (e.g. 20% of the grant vests each year for five years).
Exercise methods

- Cash
- Stock you already own (a stock swap)
- Cashless same-day sale
- Sell-to-cover exercise
- Promissory note
- Net options exercise
Cash exercise

- The simplest exercise method is the use of cash to pay the exercise cost.

Example: You have an NQSO to purchase 100 shares of your company's stock at an exercise price of $10 per share. When the stock reaches $15 per share, you exercise your entire option using cash. To complete the exercise, you write a check to the company for both the total exercise price of $1,000 and the taxes on the $500 spread.
A cashless exercise is an exercise-and-sell transaction in which you do not have to come up with the cash needed to pay the exercise price and the amount required for tax-withholding. Instead, you simultaneously exercise your option and sell the stock.

**Example:** You have 10,000 NQSOs with a $15 exercise price. You need $150,000 for the exercise cost. The market price is $25, giving you a spread of $100,000 [($25 – $15) x 10,000]. Your total federal, state, and Social Security/Medicare taxes at exercise on the spread equal 35% ($35,000). The brokerage commission is $500.

**Proceeds needed from exercise and sale:** $185,500 at exercise to cover the exercise cost ($150,000) and taxes ($35,000) paid to your company, and commission ($500) for the stock sold.

**Proceeds from sale:** $250,000 ($25 x 10,000 shares).

**Proceeds you receive from cashless exercise:** $64,500 ($250,000 – $185,500).
A sell-to-cover exercise is a type of cashless exercise in which the broker sells just enough of the shares from your exercise to pay the exercise price, any tax withholding, and the broker's transaction fees. You receive the remaining shares.

**Example:** You have 10,000 nonqualified stock options (NQSOs) with a $15 exercise price. You need $150,000 to cover the exercise cost. The market price is $25, giving you a spread of $100,000 \([($25 - $15) \times 10,000]\). Your total federal, state, and Social Security/Medicare taxes at exercise on the spread equal 35% ($35,000). The brokerage commission is $500. **Proceeds needed at exercise:** $185,500 at exercise to cover the exercise cost ($150,000), taxes ($35,000), and commission ($500).

- **Shares sold in sell-to-cover exercise:** 7,420 ($185,500 divided by $25).
- **Shares you keep from exercise:** 2,580 (before subtracting any broker's fee for the transaction).
Other exercise methods

- A stock swap, or stock–for–stock exercise, is a stock option exercise in which the exercise price is paid with shares of company stock you own.
- Some companies use a “net options” exercise, in which you return or surrender to the company some of the stock options with a spread value that covers the total cost of exercising and holding. The number of shares you receive will equal the value of your exercise spread.
NQSO taxation at exercise

The spread at exercise is included as ordinary income in your gross income for that year.

Example: You have stock options with a $10 exercise price. You exercise them after vesting when the price of your company stock is $12. You have a $2 spread ($12 – $10) and thus $2 in ordinary income. You will also have tax withholding when you exercise the NQSOs.
NQSO taxation at exercise

- Income received at exercise is subject to mandatory federal supplemental wage withholding (usually 22%, but 37% for amounts above $1 million in a calendar year).
- The spread at exercise is subject to Social Security and Medicare taxes, along with any applicable state and/or local taxes.
- The income and withholding taxes will appear on your [Form W–2](#) in the appropriate boxes.
When you sell the shares, you are taxed on your capital gains, as with any stock you purchase.

- Capital gains tax applies to the amount of your gains above your tax basis after exercise.
NQSO taxation at sale: example

- Exercise price: $12
- Market price (used to calculate the spread at exercise): $18
- Stock price at sale: $26
- You have $6 per share ($18 – $12) of ordinary income at exercise and $8 ($26 – $18) of capital gains at sale
- The capital gains are taxed at 15% or 20%, depending on your income
NQSO taxation at sale

- Capital gain may be short-term (from securities held 12 months or less) or long-term (from securities held more than 12 months).
- To calculate the holding period, start with the day after your acquisition date and stop counting on the day when you sell the shares.
How is capital gain calculated?

- The amount of your capital gain is the difference between your sales price and your tax basis in the stock.
- With your NQSO exercise, your basis in NQSO stock equals your exercise price plus the amount of income you reported for the spread.
- Thus your tax basis is usually equal to the fair market value of the shares on the exercise date.
- If the sale price of your stock is lower than your tax basis, you have a capital loss. Capital losses are used to offset capital gains to establish a net position for tax purposes.
NQSO tax return reporting

- You must file Form 8949 and Schedule D with your federal Form 1040 tax return for any tax year in which you have sold shares.
- You must file these regardless of whether you have a gain and even if you sold option stock immediately at exercise (i.e. cashless exercise, same-day sale).
- On your tax return, you report the exercise date as your purchase date, even though your holding period does not begin until the following day.
In our Tax Center, detailed FAQs with annotated diagrams explain all aspects of NQSO tax return reporting.