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GIFTING STOCK OPTIONS

by Robert W. Wood • San Francisco

Stock options have long been an attractive form of incentive compensation for executives. Particularly in the until-recently-burgeoning high-tech sector, options have been heaped on just about everyone else, too, not merely on executives. Although most stock option programs do not allow for transferability of the options, there has long been interest in making gifts of compensatory stock options, allowing the benefitted employees to do a little tax and estate planning of their own. With a merger or acquisition in the offing, gifts of options may be particularly attractive.

This is one more place in which we need to separate nonqualified options from ISOs. Gifts of incentive stock options (ISOs) may not be made, since Section 422(b) of the Code expressly prohibits their lifetime transfer. Nonqualified stock options, on the other hand, may be the subject of a lifetime transfer, as long as a transfer is permitted under the applicable stock option plan.

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True "free" transferability of stock options is rare, but many companies that wish to benefit key employees are now amending their stock option plans (again, only nonqualified plans) to allow a limited form of transferability. The most common form of limited transferability is to allow gifts to family members or to trusts for the benefit of family members. This is particularly true where the company may be looking down the road to an acquisition, thus making the options of significantly greater value.

The IRS and Its Slow Acquiescence

The IRS has long been suspicious about gifts of options. Still, of late there have been signals that both the income tax and gift tax consequences of option transfers can be well-managed. In several private letter rulings, transfers of nonqualified stock options were held to constitute completed gifts for federal gift tax purposes. Likewise, these rulings held that the gifts of the options did not result in the options being includable in the donor's estate when transferred to a properly structured irrevocable trust. The rulings also hold that the special valuation rules (set forth in Internal Revenue Code Sections 2701 and 2703) did not apply.

Finally, the Service concludes that the original optionholder remained liable for income tax when the options were exercised by the donee. See Private Letter Rulings 9725032, 9722022, 9616035 and 9350016. This last element can be a surprise for those who don't do their planning carefully, but it actually makes perfect sense if you think about it.

Before embarking on a brief discourse about planning to transfer options, it is worth noting that there can be securities law implications to these transfers besides the obvious tax implications. Giving stock options was simplified by the 1996 change to Rule 16b-3, promulgated under Section 16 of the Securities Exchange Act of 1934. The recent change removes the requirement that options be nontransferable in order to be exempt from the Section 16(b) short swing profits restrictions of that act.

Strategy: Give and Save

Persons gifting stock options should readily see the potential transfer tax savings. Options are, by their very nature, nonmarketable. Furthermore, other restrictions may be pertinent in the case of particular stock option plans. Nonmarketability (as well as more particular restrictions) may reduce the value of the option for gift tax purposes. Appraisers valuing options have also applied substantial valuation discounts to result in the gift—for gift tax purposes, anyway—having a relatively small value.

When the original optionholder pays the income tax triggered by the donee's exercise of the nonqualified option, this amounts to a transfer for the benefit of the donee that is not treated as a taxable gift. In other words, the exercise by the donee does trigger a tax, and the tax is still on the donor. However, the fact that the donor pays that tax does not mean there is an *additional* taxable gift. That is pretty neat. The stock acquired by the donee receives a basis equal to the exercise price of the stock plus the donor's taxable income on the exercise. This in turn reduces the donee's capital gains tax when the stock is later sold.

Finally, suppose that the options are transferred before they have value, in other words, when the strike price is higher than the underlying stock's current market value. Another way of referring to this situation: if the transfer is of options that are not yet "in the money." Here, is there a gift?

The answer is no. All of the post-gift appreciation in the value of the option would be in the hands of the donee and not in the hands of the donor. This can be pretty slick tax planning for optionholders and their families.

Recent IRS Pronouncements

Unfortunately, all of this meandering changed recently with both a revenue ruling and revenue procedure. Revenue Ruling 98-21 deals with

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The M&A Tax Report,
Dept. ADV,
PO Box 3000, Denville, NJ 07834

Customer services: (800) 562-1973

Editorial queries:
Robert W. Wood
Robert W. Wood, P.C.
477 Pacific Avenue, Suite 300
San Francisco, CA 94133
(415) 834-1800

Editor: Robert W. Wood

Publisher: Dean Vogel
Director of Circulation: Gerry Centrowitz
Product Development: Carol Lillienstein
Managing Editor: Elizabeth Daniele
Production: Michele Jankowski

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so-called nonvested options. Revenue Procedure 98-34 provides a safe harbor for valuing options for gift tax purposes. Both of these pronouncements from the IRS are must reading for anyone considering gifting stock options.

Revenue Ruling 98-21, 1998-18 I.R.B. 7, addresses the question of when an optionee's transfer of a nonqualified stock option to a family member for no consideration is a completed gift. The optionee held nonqualified options under an option plan that permitted transfers to immediate family members or trusts for their benefit. The plan allowed the options to be exercised only after the optionee performed additional services for the employer. These nonvested options were given to one of the children involved in the ruling.

Under the circumstances, the IRS stated that the exercise of the options was conditioned on the performance of additional services, and that until those services were performed, the optionee had no enforceable property rights that were susceptible to transfer for gift tax purposes. Thus, Revenue Ruling 98-21 holds that there is a completed gift only once the optionee performs the additional services. Where the options were to be exercisable in stages (as is commonly the case) then each portion of the option that became exercisable at a different time would be treated as a separate option for purposes of gift tax analysis. The same reasoning applies for generation skipping tax purposes, where the transfers are to a grandchild.

In short, Revenue Ruling 98-21 rules that completed gifts of nonvested stock options take place upon the later of:

- the transfer of the stock options; or
- the time when the donee's right to exercise the options is no longer conditioned on the performance of services by the donor.

Basically, the IRS is saying that a gift of nonvested options is simply not complete until the options become vested.

Valuation Safe Harbor

As noted, Revenue Procedure 98-34, 1998-17 I.R.B. 1, provides a safe harbor for valuation of stock options. This applies not only for gift tax purposes, but also for estate tax purposes and even generation skipping transfer tax purposes. It applies only to valuing non-publicly traded compensatory stock options on publicly traded stock.

The safe harbor allows taxpayers to use an option pricing model that takes into account specific factors similar to those established by the Financial Accounting Standards Board (FASB) in Statement of Financial Accounting Standards No. 123 (FAS 123). FAS 123 determines "fair value" for stock options granted by public corporations using an option pricing model such as Black-Scholes or a binomial model that takes into account the option grant date and six factors that are enumerated in Revenue Procedure 98-34.

Interestingly, the revenue procedure says no discount can be applied to the evaluation produced by one of these option pricing models. Specifically called out are lack of transferability discounts, or discounts due to a termination of the option within a specified number of days following employment termination.

Looking Forward

It seems obvious that the issuance of Revenue Procedure 98-34 and Revenue Ruling 98-21 give the IRS imprimatur to gifting stock options. Indeed, the technique is becoming more and more common. However, the revenue ruling is, to say the least, aggressive on the part of the Service. Its drawing the line at nonvested options seems arbitrary and might be subject to attack. Indeed, many attorneys believe that completed gifts can be given of nonvested stock options, at least before the Service's administrative announcement in Revenue Ruling 98-21. Obviously, in the wake of Revenue Ruling 98-21, relatively few people want to go against a published ruling and suffer the potential consequences. Consequently, some people may be looking at ways to accelerate the vesting of options so that the ruling loses its vim and vigor.

Similarly, there are a good number of people who are scratching their heads over the Service's statements in Revenue Procedure 98-34 that valuation discounts are not appropriate. Appraisers normally do consider these factors, and it seems wholly appropriate for them to be taken into account. Thus, the existence of this safe harbor (with its disallowance of discounts) will probably not change the approach taken by appraisers all that much. Of course, the safe harbor (for whatever it is worth!) only applies to non-publicly traded compensatory stock options on *publicly* traded stock. Thus, by its terms, the revenue procedure does not apply to options on stock in private companies. That will mean that the safe harbor is of even less benefit than it otherwise could be.

All in all, we can expect more developments in transfers of stock options. In fact, the Service may potentially even have to defend itself on the positions taken in Revenue Ruling 98-21. Meanwhile, planners will probably be attempting to avoid its strictures.