ADVISOR'S QUARTERLY

Making Sense of Employee Stock Options

Donald C. Meyer, Esq., Planned Giving Consultant

Employee stock options have contributed greatly to the new wealth created by individuals over the past 15 years. This wealth tends to arrive quickly, without the decades-long build-up typical of wealth creation in prior generations. It often belongs to individuals without a history of wealth in their families, and who are generally young, with a major part of their family and work lives in front of them. Many are charitably inclined, hold assets beyond their dreams, and have not developed strong emotional ties to their holdings.

Because of the widespread use of stock options today, gift planning officers need to have a basic understanding of the rules governing contributions of employee stock options to charity or to a charitable remainder trust (CRT). From an overall standpoint, the tax code does not favor the donation of stock options; however, there are some strategies that may provide tax benefits in limited situations. This article will survey the basic tax treatment of employee stock options and review possibilities and pitfalls associated with gifts of these assets.

An employee stock option gives a corporate employee (and in some cases, a board member) the right to purchase stock from the corporation at a pre-specified "exercise price" and over a stated period of time. If the price of the company's stock increases over time, the option becomes more valuable, since the exercise price is fixed. Under the tax code, there are two basic forms of options: incentive (or qualified) stock options (ISOs) and nonqualified stock options (NQSOs).

Incentive Stock Options

Basics. There are no tax implications when an employee receives an ISO. When the employee later exercises the ISO, he or she recognizes no gain for regular tax purposes, although the excess of the value of the stock over the exercise price is a preference item for alternative minimum tax (AMT) purposes. Many highly compensated corporate executives are subject to the AMT.

When the stock is later sold, the tax implications are as follows. If the employee held the stock for at least two years after the option was originally granted ***and*** at least one year after the stock was acquired through the exercise of the option, then the subsequent sale of the stock will result in long-term capital gain. If either of the above holding requirements is not met prior to the sale of the stock, a "disqualified disposition" occurs. The individual must then recognize ordinary income based on the difference between the fair market value (FMV) of the stock at the time the option was exercised and the exercise price. In addition, if the stock was held for less than a year, any excess of the sales proceeds over the FMV of the stock at the time of the exercise will be taxed as short-term capital gain.

Stock acquired by exercising incentive stock options can later be given to charity.

Lifetime Gifts. ISOs, under IRS rules, cannot be transferred by an employee during lifetime; therefore a gift of the option to charity is not possible. However, if stock acquired upon exercise of the ISO is held for ***more*** than one year, it can be contributed to charity, and the employee/donor will receive a charitable deduction based on the FMV of the stock at the time of the gift. (Note, however, that the two-year holding period, described above, must still be met in order to avoid a disqualified disposition.) If the stock has been held ***less*** than one year following the exercise, the employee/donor's deduction for any charitable gift will be limited to his tax basis in the stock, usually the exercise price.

Prospective donors who have valuable, but unexercised, ISOs may well be in a position to make a charitable gift of highly appreciated stock two or three years into the future (a horizon that often lies within the anticipated time frame of charities' capital campaigns).

Testamentary Gifts. ISOs generally can be transferred to charity at an individual's death, provided the stock option plan permits. Also, the stock received from the exercise of an ISO can be bequeathed to charity without

adverse tax consequences, since a bequest is not considered to be a "disqualified disposition."

Non-Qualified Stock Options

Basics. NQSOs are more commonly used today than ISOs. Transfers of NQSOs are permitted, so long as the corporation's stock option plan allows for it. However, many such plans make no provision for charitable gifts of options, making it necessary to secure an amendment to the plan (which can have undesired consequences in other respects) or, if counsel for the company approves, a waiver or exemption.

The income tax treatment of NQSOs is different than for ISOs. (NQSOs are covered under Internal Revenue Code §83, whereas ISOs are governed by §421 and §422.) As a general rule, NQSOs are not taxable to the employee when they are issued. However, when the employee subsequently exercises the option, ordinary income must be recognized in an amount equal to the difference between the FMV of the stock at the time of exercise and the exercise price. If the stock acquired upon exercise of the NQSO is held for more than one year prior to sale, the excess of the sales proceeds over the FMV of the stock at the time of exercise will be treated as long-term capital gain.

Lifetime Gifts. If a NQSO is given to charity, there are no tax implications upon transfer. However, when the charity subsequently exercises the option, the employee/donor must recognize ordinary income as if he or she still held the option. NQSOs do not offer the possibility of avoiding tax on the gain inherent in the options.

Charitable gifts help to offset ordinary income recognized upon the exercise of non-qualified stock options.

There is also no clear legal authority on whether the donor will receive a charitable deduction for the gift of a NQSO to charity. Some believe, based on the assignment of income doctrine, that the donor's charitable deduction should be allowable when the NQSO is transferred. Others believe the deduction should be allowable when the option is exercised by the charity. But in either case, because the donor would have recognized ordinary income (and not long-term capital gain) if he had sold the option himself, the reduction rule of IRC §170(e)(1)(A) will limit the deduction to the donor's basis. That basis would be zero if the deduction was deemed allowable upon transfer, or equal to the ordinary income recognized by the donor upon the charity's exercise of the option, if the deduction was deemed allowable upon exercise.

The requirement to recognize ordinary income when the charity exercises the option coupled with the uncertain availability of a charitable deduction discourages donors from contributing NQSOs to charity during lifetime. However, donors who choose to exercise NQSOs will recognize significant ordinary income, and gift planners know how to help donors with this tax problem! Often these donors own stock in the same corporation that has been held over one year. A gift of this stock (or other long-term appreciated assets), coincident with the exercise of NQSOs, could provide an income tax deduction to offset the income that must be recognized.

Of course, if the employee/donor exercises an NQSO and then holds the stock for more than one year, the employee will receive a charitable deduction for a subsequent gift of the stock to charity based on its FMV at the time of the gift.

Testamentary Gifts. NQSOs can be attractive testamentary gifts to charity. The IRS has ruled that an employee's bequest of a NQSO to charity will result in income in respect of a decedent (IRD) to the charity (and not to the donor's estate) when the option is exercised. However, because the charity pays no taxes, it can effectively realize the value in excess of the exercise price tax-free.

Stock Options and Charitable Remainder Trusts

In those instances described above where it is legally possible to contribute stock options to charity, it is also possible to contribute them to a CRT, but the same tax difficulties are present. If options are given to a CRT, the trustee should take care when arranging for the funding necessary to exercise the options. If debt is incurred in order to pay the exercise price, the gain to the CRT upon exercise might be considered debt-financed and consequently taxable as unrelated business taxable income. To avoid this problem, the donor (or the estate plan) should contribute additional liquid assets to the CRT that can be used to exercise the option.

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