ROBERTS & HOLLAND LLP

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Compensatory Stock Options: IRS Provides Some Guidance on Gift and Estate Tax Issues

By: Elliot Pisem

"Nonstatutory stock options" are a popular form of compensation in corporate America. These options take their name not from being in *violation* of any statute, but rather from the fact that their tax treatment is governed by a potpourri of rules many of which are found only in judicial decisions or Treasury Regulations, rather than in the Internal Revenue Code (the "Code") itself. (At the present time, the only form of "statutory stock options" are "incentive stock options" ("ISO's").[1]

The basic income tax rules governing nonstatutory stock options are well-established. As a general matter, if an employee is granted a nonstatutory stock option which is not actively traded on an established market and does not itself have a readily ascertainable fair market value at the time of the grant, the granting of the option is not itself a taxable event to the employee. Rather, the employee's taxable event occurs when the option is exercised or, if the stock received upon exercise of the option is itself subject to a substantial risk of forfeiture, when that risk lapses. Only if either (1) the option is actively traded on an established market or (2) the option does have a readily ascertainable fair market value at the time of grant (and certain other conditions are met[2]) does a taxable event occur at the time that the option is granted. The employer is generally entitled to its compensation deduction at the same time that the employee includes an amount in income.

The popularity of stock options—both those of the nonstatutory variety and ISO's—as a compensation technique has led to a further level of tax questions. When such options constitute a significant part of an employee's wealth—or may constitute a significant asset in the future if the underlying stock increases in value—the employee may desire to transfer that wealth to children (or others), by the making of gifts. Alternatively, an employee may die while holding an unexercised stock option. It has become important, therefore, to obtain greater certainty regarding the gift and estate tax consequences that attach to stock options. The Internal Revenue Service addressed some of these questions this past May 4 in Revenue Ruling 98-21 and Revenue Procedure 98-34.[3]

In Revenue Ruling 98-21, "Company" had granted to "*A*" a nonstatutory stock option to purchase shares of Company common stock. The option was not "vested," in that *A* was obligated to perform additional services prior to exercising the option; however, once the option was exercised, the acquired stock would be freely transferable and not subject to other restrictions or limitations. The exercise price of the option was equal to the market value of the underlying stock on the date the option was granted. Although the

option was not vested, *A* was permitted to transfer it to one of *A*'s children and *A* in fact did so for no consideration. *A*'s child was not permitted to exercise the option until *A* had completed the requisite vesting service.

The issue in the ruling was when the transfer of the option would be considered a "completed gift" for gift tax purposes. If the transfer was a "completed gift," it would be subject to gift tax and the value of the gift would be computed at the time of the transfer. On the other hand, if the transfer were considered to be a "completed gift" only at a later time, the imposition of any gift tax would be deferred, but, when the gift tax was ultimately imposed, it would be computed by reference to the value of the option (and, thus, of the underlying stock) at a later time; if the stock went up in value, the increased value subject to gift tax might more than offset the benefit of deferring the taxable event.

The Service noted that a gift is taxable when it is a gift of "property" that has been "completed" by the donor's "so part[ing] with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another."[4] In the Service's view, the fact that *A*'s failure to continue to perform services could cause the option never to be exercisable caused *A*'s rights in the option not to have the "character of enforceable property rights susceptible of transfer for federal gift tax purposes."[5] Thus, no completed gift occurred until *A* had performed sufficient services for the option to become vested and the gift tax was to be imposed at that later time and at the (presumably higher) value of the option at that time.

Revenue Ruling 98-21 dealt with *when* and *whether* the gift tax would be imposed on a transfer of a nonstatutory stock option. Revenue Procedure 98-34 deals with the question of *valuing* certain compensatory stock options for purposes of gift and estate taxation and provides a methodology, which is effectively a "safe harbor," on which taxpayers can rely in cases falling within its scope. The new safe harbor will apply only if a number of tests are met, including: (1) the compensatory stock option is *not* itself publicly traded; (2) the underlying stock *is* publicly traded on an established securities market; (3) the employer granting the option is subject to Statement of Financial Accounting Standards No. 123 ("FAS 123"), Accounting for Stock-Based Compensation, established by the Financial Accounting Standards Board; (4) the underlying stock is common stock; and (5) no discount is applied to the valuation produced by the safe harbor pricing model.

If these tests are met, the option may be valued under a "generally recognized option pricing model," including specifically the "Black-Scholes model" or an "accepted version of the binomial model," using certain specific factors for the expected life of the option, the expected volatility of the underlying stock, the expected dividends on the underlying stock, and the "risk-free interest rate" computed as set out in the Revenue Procedure (in a manner which is generally derived, with some adjustments, from the amounts disclosed by the employer under FAS 123) and other reasonable assumptions. Gift and estate tax returns reporting transfers of options that are valued under the safe harbor must specifically disclose that fact.

Obviously, the determination of whether the certainty and relative simplicity afforded by use of the safe harbor outweigh the possible tax savings of computing the value of an option under other methods (including those taking into account various valuation discounts) can be determined only on a case-by-case basis. However, the safe harbor method seems likely to be the beginning, if not both the beginning and the end, of any estate or gift tax valuation inquiry relating to compensatory stock options.

This new guidance from the Service does not, of course, answer all of the questions that may arise regarding the gift and estate taxation of compensatory stock options. Moreover, some tax advisors have expressed reservations about the correctness of some of the positions that the Service has taken. In any event, though, we have all received a timely reminder of some of the opportunities and pitfalls inherent in owning and transferring stock options.

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[1] ISO's are governed by sections 421-424 of the Code. The fair market value of stock with respect to which ISO's can be exercised by any individual during any year is limited to $100,000.

[2] These conditions, which do not apply in the case of options actively traded on an established market, relate to the transferability and immediate exercisability of the option and the absence of any restrictions that have a significant effect on the fair market value of the option. If these additional conditions are not met, an option which is not actively traded on an established market is considered not to have a readily ascertainable fair market value, regardless of whether, as an exercise in the science (or art) of securities valuation, a fair market value could in fact be readily ascertained for the option.

[3] 1998-18 I.R.B. 7 and 15, respectively.

[4] *See* Treasury Regulation section 25.2511-2(b).

[5] It is interesting that the Service did *not* say that *A*'s ability to divest *A*'s child of the economic benefit of the option by failing to perform services constituted a retention of "dominion and control" on *A*'s part. As the theory of the ruling comes to be applied in somewhat different factual settings, this distinction may be of some significance.

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