Giving away your employee stock options

Stock options could be the single most valuable asset that many individuals own. If you have unexercised stock options, you should consider the unique ways in which a gift of stock options may further your estate plan.

In 1996 the Securities and Exchange Commission changed its rules to allow the transfer of nonqualified stock options used in compensation programs. (Incentive stock options, however, are not affected by the change). Companies soon amended their plans to permit transfers, and many people began taking advantage of the chance to preserve substantial amounts of wealth in the family at relatively little transfer tax cost.

For example, assume that an option on 10,000 shares is exercisable at $100 per share, well above the stock's current market price of $75. The executive transfers the option to a child (or to a trust for the child), and the taxable value of the gift will be relatively low, so that a minimal gift tax is due. After a number of years, assume that the market price of the shares has reached $200. When the option is exercised, the child will own shares worth $2 million, at very little transfer tax cost.

Careful planning is needed

In a ruling just a few years ago, the IRS looked at a stock option plan in which an executive was required to perform additional services for the employer or risk forfeiture of the option. The individual made a gift of the option to one of his children before performing the necessary services. The ruling does not provide additional detail, but the plan might, for example, have made the options exercisable after three years with an expiration after ten years. IRS concluded that the requirement of additional services by the executive meant that the gift was not complete, and therefore not taxable, when the gift of the stock options was made. The gift will be completed only when the additional services have been provided and the right to exercise the option is absolute. That's when the gift tax could come due.

In a rising stock market, delaying the moment at which the gift is complete will tend to increase the value of the option and increase the transfer tax cost of making the gift. (See *"How to Value a Gift of a Stock Option"* at the end of this article for the factors that will affect the taxable value of the gift.)

Who owes the income tax?

Income must be recognized when the stock option is exercised—the difference between the exercise price and the stock's fair market value is ordinary income. Under IRC Section 83 the income tax falls on the individual who received the option as compensation. This is true even if the option has been transferred to a family member. What's more, the payment of the income tax does not result in a taxable gift to the owner of the option—in effect, this is an additional tax-free transfer. Payment of the income tax by the executive will diminish his or her eventual estate tax obligation, while it increases the basis of the stock in the hands of the transferee.

How to value a gift of a stock option

Whenever a gift of stock options is complete, a gift tax may be due, depending upon the value of the gift.

The IRS has provided some official guidance on valuation, looking to the authority of the Financial Accounting Standards Board. Six factors need to be taken into account in valuing the option:

1. the exercise price of the option;
2. the expected life of the option;
3. the current trading price of the underlying stock;
4. the expected volatility of the underlying stock;
5. the expected dividends on the underlying stock; and
6. the risk-free interest rate for the remaining option term.

The mathematics for putting these factors together may follow the Black-Scholes model for valuing stock options, and some implementation details are provided by the IRS.

No additional discount can be applied to the value determined with this pricing model. For example, no discount is allowed for lack of transferability of the option outside the employee's immediate family, or to reflect the risk of termination of the option within a certain period following the termination of employment.

Example: According to CCH Incorporated, the value of an option to buy a share at $25, if the current price of the stock is $20, is $7.98, assuming 30% price volatility and an eight-year term. If the strike price were $35, the value of the option would fall to $5.71 under the Black-Scholes formula.

Any developments occurring after January 15, 2007, are not reflected in this article.