Estate Planning *Fast* Faxts

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Estate, Tax and Family Wealth Preservation Planning For Advisors

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Gifting Stock Options As An Estate Planning Strategy

Stock option compensation has been growing in importance for some time. In fact, stock option grants now comprise nearly 40 percent of total compensation to senior management of U.S. corporations, up from 25 percent in 1993. Stock option grants, which hold enormous potential for future appreciation, have caught the attention of many an estate planner. Coinciding with the boom in family limited partnerships (FLPs), the growth in stock option grants has led to a strong lobbying effort directed at corporations by executives and their advisors to allow transfers of these options into FLPs or family trusts. Stock options represent the ultimate in leverage. If done properly and given the right circumstances, an option-gifting strategy can be one of the most tax-efficient ways of transferring wealth yet devised.

For some time, there were two major obstacles impeding wide-spread adoption of stock options gifting strategies: (1) such transfers were prohibited in many corporations' stock options plans; and, (2) confusion over what the tax treatment would be. On the corporate front, although many employers still have highly restrictive transferability language in their stock option plans, more and more are now amending their plans to permit transfers of stock options to immediate family members, FLPs, and family trusts. On the tax front, the Internal Revenue Service recently published Revenue Ruling 98-21 and Revenue Procedure 98-34, and much of the confusion over tax treatment has decreased. Revenue Ruling 98-21 provides guidance on the effective time that a completed gift occurs when nonstatutory (i.e., non-qualified) stock options are transferred. Revenue Procedure 98-34 provides safe harbor guidelines for the valuation of stock options for transfer tax purposes.

THE GIFTING STRATEGY

The transfer of appreciating assets to succeeding generations is a principal tenet of sound estate planning. Stock options are a logical choice for such transfers. "Call" options, which increase in value as the underlying shares increase in value, are the only type of option that lends itself to this particular gifting strategy.

The ideal transfer utilizes a fair degree of "leverage". The leverage is best utilized if the options are gifted immediately after they are granted, before any appreciation in the value of the underlying stock.

A complicating factor in the valuation of many employee stock options is that they are granted with vesting provisions. In these cases, an immediate transfer means that some or all of the options will not be vested at the time of transfer. Further, there is a chance that some of the options may never become vested, due to circumstances which are difficult to predict, such as the failure to attain certain performance benchmarks or the termination of employment. These factors present challenges to estate planners, since according to Revenue Ruling 98-21, transfers of unvested options are not considered completed gifts until the time of vesting. For gift tax purposes, the value of the gift cannot be determined until that point in the future when the options become vested.

WHAT TO DO

For those individuals who wish to make gifts and have been granted stock options as part of their compensation, early gifting of those options can make a lot of sense. This is especially true now, given recent developments on the corporate and tax fronts. Valuation experts can apply methods that address complicated provisions, so valuation should not be a hindrance to implementing what can be a very advantageous gifting strategy.

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"I don't want stock options. I want you to pay your tab."

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Quote for March:

"If you drive a car, I'll tax the street. If you try to sit, I'll tax your seat. If you get too cold, I'll tax the heat. If you take a walk, I'll tax your feet. Taxman! Well, I'm the taxman. Yeah, I'm the taxman."

—The Beatles

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