XIII. PLANNING FOR STOCK OPTIONS AND EMPLOYER STOCK OWNERSHIP PLANS

A. Introduction

Stock options and employer stock ownership plans ("ESOPs") are commonly used forms of employee compensation. Stock options allow an employee to participate in the potential future appreciation of the stock of the employer. The basic types of stock options are (i) incentive stock options and (ii) nonqualified incentive stock options. Both types of stock options allow the employee to defer the recognition of tax on any appreciation of the stock from the exercise date to the date the stock is sold.

An ESOP is a qualified plan that allows employers to make contributions of the employer's stock to an account for the benefit of an employee. Like other types of qualified plans, contributions of the employer's stock to the ESOP are not taxed to the employee and the stock can appreciate within the ESOP tax-free until distributed.

This Chapter analyzes the unique estate planning issues that must be considered when using stock options and employer stock ownership plans. The topics covered in this Chapter include:

- Incentive stock options;
- Nonqualified incentive stock options;
- Stock appreciation rights; and
- Employee stock ownership plans.

B. Incentive Stock Options

1. General Description

An incentive stock option ("ISO") gives an employee of a corporation the right to purchase stock of the employer at a set price (the "exercise price"). The employee then is allowed to "wait and see" whether the stock of the employer will appreciate over the exercise price. The question becomes when should the employee exercise the ISO? If the employee waits until the fair market value of the stock significantly exceeds the exercise price, the difference between the fair market value of the stock on the date of exercise and the exercise price may trigger an alternative minimum tax, even though the exercise of the ISO does not trigger regular income tax. If the employee exercises the ISO when the fair market value is close to the exercise price, no alternative minimum tax would be triggered, but the employee could suffer an unnecessary economic loss if the fair market value of the stock declines or the corporation goes out of business. On the other hand, if the fair market value of the stock significantly increases, the employee could enjoy long-term capital gain treatment on the disposition of the stock, provided the employee satisfies certain holding-period requirements.

2. ISO Requirements

a. **<u>IRC § 422(b)</u>**. In order to obtain the advantageous tax treatment and

deferral benefits of an ISO, the ISO must satisfy the following requirements set forth in Internal Revenue Code ("IRC") § 422(b):

- The option must be granted pursuant to a plan adopted by the corporation and the plan must be approved by the stockholders within 12 months before or after the date the plan is adopted;
- The option must be granted within 10 years from the date such plan is adopted by the corporation or approved by the stockholders, whichever is earlier;
- The option by its terms must not be exercisable after the expiration of 10 years from the date the option is granted;
- The option price must not be less than the fair market value of the stock at the time the option is granted;
- The option cannot be transferred, other than by will or the intestacy laws, and is only exercisable by the employee (the employee's personal representative can exercise the ISO after the employee's death); and
- At the time the option is granted, the employee cannot own stock equal to more than 10% of the total combined voting power of all classes of stock of the employer corporation or of its parent or subsidiary corporation.

b. **Employment Requirement**. ISOs can be held only by employees of the issuing corporation or a related corporation. The employee must exercise the ISO during employment or within three months after termination of employment. IRC § 422(a).

c. **Exercise Price**. The exercise price of an ISO must equal the fair market value of the stock on the date the ISO is *granted.* If the exercise price is lower than the fair market value of the stock on the date the ISO is granted, the ISO will not satisfy the requirements of IRC § 422(b) and therefore becomes a nonqualified incentive stock option. When the employee exercises an ISO, if the fair market value on the date of exercise is greater than the exercise price, the difference will not be included into the employee's regular income, but it may trigger alternative minimum tax.

d. **Limitation on Amount of Exercise**. IRC § 422(d) limits the amount of ISOs an employee can exercise in each calendar year to $100,000 of the aggregate fair market value of the stock.

> **EXAMPLE:** C was granted an option to purchase 50,000 shares of his employer's stock pursuant to an ISO agreement. The exercise price under the ISO agreement is $2 per share. In year 5, all of the shares of stock under the ISO agreement become vested and exercisable. In year 5, the fair market value of the stock is $10 per share. If C exercises all 50,000 shares of stock pursuant to the ISO, only 10,000 ($100,000 ÷ $10) shares of stock would qualify for tax- favored ISO treatment pursuant to the $100,000 limitation, and the remaining 40,000 shares would receive nonqualified stock option treatment. To preserve the tax-favored ISO treatment on the remaining 40,000 shares, C could exercise the number of shares up to the $100,000 limitation in each of the four

succeeding years.

e. **Holding-Period**. In order for the employee to enjoy long-term capital gain treatment on the disposition of the stock of the employer obtained through an ISO, the employee must satisfy the holding-period requirements set forth in IRC § 422(a)(1). Pursuant to IRC § 422(a)(1), the employee must hold the stock of the employer for 2 years from the date the ISO is *granted* and for 1 year from the date the stock of the employer is received (*i.e*., the date the ISO is *exercised*). The employee's tax basis in the stock is equal to the exercise price paid.

> **EXAMPLE:** C was granted an ISO on January 30, 1999. The exercise price of the stock of the employer was $5 per share. On January 30, 2007, C exercised his ISO. On the exercise date, the stock of the employer was worth $10 per share. C's basis in the stock is $5 per share. On February 22, 2008, C sold the stock for $25 per share. Since C satisfied the holding-period requirements of IRC § 422(a)(1), C would recognize a long-term capital gain of $20 per share ($25 - $5).

3. Alternative Minimum Tax

a. **General Description**. The alternative minimum tax ("AMT") is a tax based on the recalculation of a taxpayer's taxable income. Adjustments called "preference items" are generally added to the taxpayer's taxable income to arrive at the taxpayer's alternative minimum taxable income. The alternative minimum taxable income is then subject to tax at an alternative, and usually lower, tax rate. The economic benefit an employee obtains, when he or she exercises an ISO at a time when the fair market value of the stock significantly exceeds the exercise price, is not included in the employee's regular taxable income because of IRC § 421(a). The difference, however, is a preference item for AMT purposes and could subject the employee to an AMT liability.

b. **Alternative Minimum Taxable Income**. Alternative minimum taxable income is an employee's regular taxable income with various adjustments. Alternative minimum taxable income includes an amount equal to the difference between the exercise price and the fair market value of the stock of the employer on the date of exercise. This difference is a preference item that is added to the employee's regular taxable income for purposes of calculating alternative minimum taxable income.

c. **AMT Calculation**. AMT is calculated by multiplying the employee's alternative minimum taxable income by the tentative minimum tax rate of approximately 28%. The product of this calculation is the employee's tentative minimum tax. The employee's tentative minimum tax is then compared to his or her regular income tax liability. If the tentative minimum tax exceeds the employee's regular income tax liability, the difference is the employee's additional AMT liability.

> **EXAMPLE:** W, a married man, has regular taxable income of $800,000 in tax year 2001. During 2001, W also exercises an ISO with an economic benefit (fair market value of the stock on the date of

exercise over the exercise price) of $25,000. W's tax liability on his regular taxable income for year 2001 is $284,843. W's tax liability on his alternative minimum taxable income is approximately $231,000 (($800,000 + $25,000) x 28%); therefore, W has no AMT liability for tax year 2001 because his alternative minimum tax liability ($231,000) does not exceed his tax liability on his regular taxable income ($284,843). If, however, W exercises an ISO with an economic benefit of $500,000, W would have a tax liability on his alternative minimum taxable income of approximately $364,000 (($800,000 + $500,000) x 28%) and an AMT liability amount of $79,157 ($364,000 - $284,843).

➔ **Planning Point:** AMT can be avoided by limiting the number of shares that are purchased through an ISO to a number that would cause the taxpayer's tentative minimum tax to be equal to, or less than, his or her regular income tax liability. By staggering the number of shares purchased in an ISO over a number of different tax years, AMT liability can be significantly minimized or altogether avoided.

d. **AMT Credit**. The employee is entitled to claim a credit for the amount of AMT paid in prior years. In the tax years following the exercise of an ISO, the employee may no longer be subject to an AMT. In these subsequent years, the employee can claim a credit against his or her regular income tax liability for the AMT paid in the previous tax years. The credit, however, is sometimes limited and the employee may be unable to recover the entire amount of AMT paid.

➔ **Planning Point:** The use of the AMT credit can be maximized by timing the amount of regular taxable income in the subsequent tax years. If the employee has the ability to bunch income or expenses in any given year, the AMT credit could be used in the year when the employee's regular taxable income is being taxed in the highest marginal tax rates.

4. Estate Planning for ISOs

a. **Lifetime Planning**. Lifetime planning opportunities dealing with ISOs are limited because of the stringent requirements of IRC § 422. Lifetime transfers of unexercised ISOs by the employee are not permitted. Therefore, unexercised ISOs cannot be transferred to a revocable trust or to any other planning vehicles. Additionally, in order to obtain long-term capital gain treatment, the stock received upon exercising an ISO should be transferred only after the employee has met the holding-period requirements. If the stock is transferred before the expiration of the holding-period requirements, the appreciation on the stock may be taxed as ordinary income rather than as a capital gain. Therefore, the lifetime planning opportunities to transfer ISOs and remove the corresponding appreciation out of the employee's estate are limited.

b. **Testamentary Planning**. Many of the restrictions placed on an ISO for lifetime transfers do not apply after the employee dies. The requirement that the employee exercise the ISO during employment or within 3 months after termination of employment does not apply

after the employee's death. Also, the holding-period requirements on the stock received under an ISO do not apply after the employee's death. The ISO can be exercised by the employee's personal representative at any time prior to the expiration of the 10-year period set forth in IRC § 422(b), provided the employee was employed by the company within 3 months of his or her death.

➔ **Planning Point:** The elimination of the requirement that the ISO be exercised within 3 months after the employee terminates employment allows the employee's personal representative to step into the shoes of the employee. The personal representative can exercise the ISO, at any time after the date of the employee's death, to the date that is 10 years from the date the ISO is granted. Therefore, the personal representative can take the requisite time needed to fully consider when and how the ISO should be exercised.

The employee's estate planning documents should provide the personal representative with the power to exercise the ISO, to borrow funds to pay the exercise price, to pledge the stock as collateral, and the authority to act on the ISOs without court supervision.

C. Nonqualified Incentive Stock Options

1. General Rule

Nonqualified incentive stock options ("NISOs") are options that do not meet the requirements of IRC § 422 and therefore are not afforded the corresponding tax benefits described above. There is, however, more planning flexibility in dealing with NISOs because NISOs are not subject to the restrictions of IRC § 422.

2. Income Tax Consequences on Grant and Exercise of NISOs

The grant of a NISO to an employee is generally not includable in the income of the employee. In some limited circumstances, the value of a grant of a NISO can be includable in the income of the employee if (i) the option is transferable, (ii) the option is exercisable immediately and in full, (iii) there are no restrictions imposed on the ownership or sale of the NISO that would affect its value, and (iv) the option's value is reasonably ascertainable using a predictive formula. Treas. Reg. § 1.83-7(b). However, most NISO plans avoid this adverse tax consequence by requiring a vesting period in the NISO agreement.

Unlike an ISO, the *exercise* of a NISO will create ordinary income for the employee. The amount of ordinary income that must be recognized upon the exercise of a NISO is the difference between the fair market value of the stock on the date of exercise and the exercise price. Since the exercise of the NISO is included in the employee's regular taxable income, there is no AMT liability associated with the exercise of a NISO. The employee's tax basis in the shares of stock received from the exercise of the NISO would be the fair market value of the stock on the date of exercise.

3. Gift of NISO

a. **Gift and Income Tax Consequence**. A NISO can be gifted by the

employee during his or her lifetime, provided the NISO plan permits the transfer of ownership. The employee will not incur any immediate income tax liability on the transfer of the NISO by gift. Upon the exercise of the NISO by the donee, the employee will include into income the difference between the exercise price and the fair market value of the stock on the date of exercise. The donee's basis in the stock received pursuant to the exercise of the NISO is equal to the exercise price paid by the donee plus the amount of taxable income recognized by the employee as a result of the exercise (*i.e.*, the fair market value of the stock on the exercise date). If the employee pays the exercise price, the employee will be deemed to have made an additional gift to the donee for the amount paid.

➔ **Planning Point:** The employee's payment of income taxes due to the exercise of the NISO by the donee is not an additional gift by the employee to the donee. This result would allow the employee to further deplete his or her estate for the benefit of the donee without incurring any additional transfer tax.

b. **Incomplete Gift**. The gift of a NISO is not completed until the option is fully vested and exercisable. Rev. Rul. 98-21, 1998-1 C.B. 975. The value of the NISO that is not fully vested and exercisable is included in the donor's estate. If the donor has gifted the NISO and the NISO vests and becomes exercisable in subsequent years, then each time a portion of the NISO vests and becomes exercisable, the donor has made a completed gift over that portion of the NISO in that particular year.

4. Valuation of NISO for Gift Tax Purposes

A NISO has value because it gives the option holder the ability to wait and see if the stock appreciates beyond the exercise price before the stock is purchased. The value of a NISO for transfer tax purposes can be illusive because of the potential uncertainties that may surround the stock of a NISO.

a. **Black Scholes Method of Valuation**. The Black Scholes method of valuation is the most widely used method to value nonpublicly traded options. The Black Scholes method considers the following factors:

- The exercise price of the option;
- Expected life of the option;
- Current trading price of the underlying stock;
- The expected volatility of the underlying stock;
- Expected dividends on the underlying stock; and
- The risk-free interest rate over the remaining option term.

Once the value of the NISO is determined by using the Black Scholes method, a lack of marketability discount can also be applied to decrease the value of a nonpublicly traded NISO.

b. **NISO Valuation Safe Harbor**. The Internal Revenue Service ("IRS") in Rev. Proc. 98-34, 1998-1 C.B. 983, has set forth a "safe harbor" for valuing nonpublicly traded stock options. The safe harbor applies only to nonpublicly traded NISOs where the underlying

stock is publicly traded on an established securities exchange. The safe harbor uses the Black Scholes method to value the NISO, but precludes the application of a lack of marketability discount.

➔ **Planning Point:** The potential benefits and detriments of using the IRS safe harbor to value nonpublicly traded NISOs should be carefully weighed. The safe harbor may produce a value that is too high because the lack of marketability discount cannot be used. The alternative is to have the NISOs independently appraised with a lack of marketability discount, even though the appraisal may be more susceptible to an IRS attack.

5. Estate Planning for NISOs

Unlike ISOs, it is possible to transfer unexercised NISOs during the employee's lifetime. The transfer tax goal is to shift the appreciation of the underlying stock of the NISO out of the employee's estate by making lifetime gifts of the NISO. The gifts can be made outright to family members, to a trust for the benefit of family members, to a family limited partnership or any combination thereof. Once the gift of the NISO is completed, the underlying stock is removed from the employee's estate and the donee would enjoy the benefits of the post-transfer appreciation free from transfer tax.

a. Transfer of NISOs to Grantor Retained Annuity Trust. The employee could transfer the NISO to a Grantor Retained Annuity Trust ("GRAT"). The GRAT would pay the employee an annuity amount over a term of years. The annuity amount could be paid with stock. At the end of the retained annuity term, the remaining assets would be distributed to the named beneficiaries, outright or in trust. The transfer of the NISO to the GRAT is a gift equal to the present value of the remainder interest. This technique allows the employee to retain a portion of the stock, transfer the remainder to his or her children, and shift the future appreciation in the stock to his or her children.

b. Transfer of NISOs to Family Limited Partnership. The employee could transfer the NISO to a family limited partnership ("FLP"). The employee would contribute the NISO to the FLP and receive a general and limited partnership interest in return. The employee would then transfer the limited partnership interest to his or her children. The gift of the limited partnership interest would be discounted in value because the partnership agreement would significantly restrict the marketability of the limited partnership interest and restrict the control that a limited partner may have over the FLP. This technique allows the employee to retain control over the FLP while making discounted gifts of the limited partnership interests to his or her children.

c. Transfer of NISOs to FLP/GRAT Combination. The employee could also transfer the NISO to an FLP, receive general and limited partnership interests in return, then transfer the discounted limited partnership interests into a GRAT for a term of years. This would allow the employee to pay gift tax only on the present value of the remainder interest. Additionally, the limited partnership interest would appreciate for the benefit of the children outside the employee's estate.

➔ **Planning Point:** A gift of a NISO to a charitable organization can result in an unexpected and undesirable consequence. Even though the NISO has been gifted to a charity, the employee, upon the exercise of the NISO by the charity, would still be required to include into his or her income the difference between the fair market value of the stock on the date of exercise and the exercise price. The employee should coordinate with the charity to find solutions to this outcome.

D. Stock Appreciation Rights

1. General Description

Stock Appreciation Rights ("SARs") can be viewed as "phantom stock options." The company agrees to pay the employee cash, stock, or both, based on the "applicable measuring factor." The applicable measuring factor is usually tied to the market price of the corporation's stock. The SAR can be granted to an employee in conjunction with stock options to provide the liquidity needed to exercise the stock options.

2. Taxation of SARs

The grant of a SAR to an employee does not generally trigger an income tax consequence to the employee. When the SAR is exercised, the employee must recognize ordinary income equal to the cash received plus the fair market value of any property received.

3. Estate Planning for the SARs

The same planning techniques used for NISOs can be used for SARs if the SAR plan allows for transfer of ownership. The employee would incur a gift tax liability on the value of the SAR transferred. As with NISOs, the employee will also recognize ordinary income when the donee exercises the SAR and the payment of income tax by the donor will not constitute an additional gift to the donee.

E. Employee Stock Ownership Plans

1. General Description

Employee stock ownership plans ("ESOP") are generally available to employees in public and privately held corporations. An ESOP is a defined contribution plan governed by IRC § 409 that invests primarily in the stock of the issuing corporation. The employer's contribution to the ESOP plan is usually made without any corresponding tax consequences to the employee. The stock in an ESOP can also appreciate in value over time without any corresponding tax consequence to the employee. An employee is usually given the right to receive distributions in either cash or employer securities. ESOP plans are sometimes included as part of a 401(k) plan, but the ESOP portion must still comply with the separate ESOP requirements.

2. Distribution Requirements

An employee's entire interest in an ESOP must be distributed to him or her outright or over

his or her lifetime beginning on April 1 of the calendar year in which the employee retires from the company or reaches age 70½. IRC § 401(a)(9)(C)(i). If distributions to the employee begin and then the employee dies, the undistributed portion of the ESOP must be distributed to the employee's beneficiaries over a period that is equal to or shorter than the employee's original distribution schedule. If the employee dies before any distributions are made, the ESOP interest must be distributed within 5 years of the employee's death, unless the ESOP is transferred to a designated beneficiary. IRC § 401(a)(9)(B)(ii), (iii).

If the designated beneficiary is the employee's spouse, the distributions can be delayed until the later of 1 year after the date of the employee's death or the year in which the employee would have been 70½. The employee's spouse can also roll over the ESOP interest into an IRA and delay the distributions from the IRA until the spouse attains age 70½.

3. Planning Considerations

a. Lifetime Planning. During the term of employment, the employee cannot receive distributions from his or her ESOP account. However, once employment has been terminated, the employee can withdraw the vested portion of his or her ESOP account. The employee can receive the distribution in cash or in stock of the issuing corporation. The distributions received in cash can be rolled over into an IRA.

Once employment has been terminated, the employee can also request a distribution of stock from the issuing corporation in lieu of a cash distribution. The employee's tax basis in the stock is equal to the cost of the securities to the plan. If the employee elects to take a lump-sum distribution of stock, the employee will be required to include into his or her ordinary income an amount equal to the tax basis in the stock.

The "net unrealized appreciation" of the stock is not taxed until the securities are sold. "Net unrealized appreciation" is the difference between the fair market value of the stock on the date of distribution and the cost of the securities to the plan. Treas. Reg. § 1.402(a)-1(b)(2)(i). The cost of the securities to the plan is usually the employer's contributions to the plan. If the employee elects a lump-sum distribution, the recognition of the entire amount of the "net unrealized appreciation" is deferred until the employee sells the stock. If the employee elects a partial distribution, then only the portion of net unrealized appreciation that is attributable to the employee's nondeductible contributions, if any, is deferred. IRC § 402(e)(4)(A).

➔ **Planning Point:** If the cost of the securities to the plan is low, the employee should strongly consider electing a lump-sum distribution of stock because there will be little to no tax consequence resulting from the distribution. Any gain from the sale of the stock thereafter will result in long-term capital gain treatment.

b. **Testamentary Planning**. If the employee dies while still employed by the corporation, the beneficiary of the employee will receive the same tax-deferred benefits of an ESOP as the employee. The beneficiary can also choose to take a distribution of cash or of stock. If the beneficiary receives stock and elects a lump-sum distribution, he or she can defer tax on the "net unrealized appreciation" until the stock is sold. Unfortunately, the beneficiary would not, however, receive a step-up in basis on the stock at the death of the decedent because the "net unrealized appreciation" is treated as income in respect of a decedent under IRC § 691. Any gain on the sale of the stock by the beneficiary will result in long-term capital gain treatment.

4. Succession Planning for Closely Held Businesses

a. **Sale of Closely Held Stock**. IRC § 1042 allows an owner of a closely held corporation to sell his or her shares of stock to an ESOP and recognize no gain on the sale. The owner must sell his or her shares of stock to an ESOP, and immediately after the sale the ESOP must own at least 30% of each class of outstanding employer stock or 30% of the total value of all outstanding stock. IRC § 1042(b)(2). The owner, in order to have no recognition of gain on the sale, must purchase qualified replacement property within a 15-month period beginning 3 months prior to his or her sale of stock to the ESOP.

b. **Qualified Replacement Property**. The term "qualified replacement property" is defined under IRC § 1042(c)(4) as securities issued by a domestic operating corporation other than the corporation that issued the stock involved in the ESOP sale transaction or any of its controlled group members. A domestic operating corporation is a corporation with more than 50% of its assets used in the active conduct of a trade or business during the replacement period. Additionally, the domestic operating corporation cannot have passive investment income exceeding 25% of the gross receipts for the preceding taxable year.

c. **Disposition of Qualified Replacement Property**. If the owner of qualified replacement property sells or transfers the qualified replacement property, he or she will recognize gain. However, no gain is recognized if the owner transfers the property:

- In any reorganization under IRC § 368 that does not involve another corporation owned by the owner;
- By reason of the death of the person making such election;
- By gift; or
- In any transaction to which IRC § 1042(a) applies.

Qualified replacement property can be gifted without triggering the recognition of gain. The donee, however, would receive a carryover basis in the stock received.

➔ **Planning Point:** The business owner can diversify his interest in a closely held corporation into publicly traded securities without triggering a capital gain tax. On the other hand, the securities distributed do not get the basis step-up at death that other securities would receive. The "net unrealized appreciation," not included in the income of the employee at the time the

stock was distributed, is treated as income in respect of a decedent to the beneficiary under IRC § 691.