April 17, 1998

Transferable Option Developments-- IRS Rules on Transferring Unvested Options

The Internal Revenue Service (IRS) issued much awaited pronouncements on April 13 providing guidance on two of the most significant issues facing companies that have permitted, or are considering permitting, the transfer of executive stock options for estate planning purposes.

- Revenue Ruling 98-21[1] states that the gift of an ***unvested*** option is ***not*** a completed gift. This means that the value of the gift is not determinable until the vesting date, thus the transfer of an unvested option is essentially precluded.
- Revenue Procedure 98-34 [1] provides clear guidance on valuing transferred options, and most significantly clarifies that pricing models such as Black-Scholes should be used to determine the value, and that discounts are not permitted for characteristics such as inability to trade. In addition, a clear formula for calculating an option's expected life is laid out.

Completed Gifts

According to Revenue Ruling 98-21, a transferred option does not become a completed gift until the date the option becomes vested. The IRS ruled that a transfer of a non-statutory stock option to a family member for no consideration is a completed gift under Internal Revenue Code §2511 on the later of (i) the transfer or (ii) the time when the donee's right to exercise the option is no longer conditioned on services by the transferor. Since the value of the gift is not determined until the vesting date, transfers before that date would be meaningless in most cases.

The attractiveness of transferring an option from an estate planning perspective comes from the tax benefit of paying gift tax on the option when the value is low, avoiding any estate taxes on the underlying shares and having the heirs gain from the option after the price has significantly appreciated.[2] Since a stock option will often be least valuable immediately after grant when there is little or no gain, that is typically the time when it would be most advantageous to transfer it. But since most option grants do not vest any earlier than one year after grant, and in many cases vest over the first three or more years after the grant, the value of the transferred option is likely to be higher, perhaps much higher, due to the subsequent gain in stock price. Therefore the tax benefit to the estate may be substantially less.

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[1] Revenue Ruling 98-21 and Revenue Procedure 98-34 are scheduled to appear in Internal Revenue Bulletin 1998-18, dated May 4, 1998.

[2] See our letter dated October 7, 1996, for a more complete discussion of this issue.

Option Valuation

Anecdotal evidence has suggested that financial advisors may have been aggressively seeking the lowest possible value for transferred options, particularly in calculating expected option lives and applying discounts for, among other things, the lack of a public market and the forfeitability of the option. Revenue Procedure 98-34 brings this to an abrupt end.

- It specifies that a taxpayer's valuation of a stock option will be accepted by the IRS if determined using a generally recognized model, such as the Black-Scholes model or an accepted version of the binomial model that takes into account the six usual factors.

- No discounts may be applied to the calculated option value.

  - For example, haircuts for lack of further transferability and illiquidity

- The expected option life must be the maximum life of the option or the adjusted expected life calculated in accord with the company's FAS 123 footnote disclosure in the annual report for the year in which the completed gift occurs.

  - In certain cases, such as when the transferor is not the employee to whom the option was granted by the company, the expected life must be the maximum remaining term

Together, these statements put a serious crimp in the attractiveness of transferring executive stock options. Certainly they do not eliminate the opportunity for the executive to benefit from stock option transfers. In cases in which the stock price is relatively flat, or even declines, between grant and vesting, the benefits are the same as they were originally thought to be. But in a bull market with increasing stock prices, these pronouncements could significantly impact the tax benefit the executive may receive.

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General questions regarding this letter may be addressed to Mike Thompson in our Chicago Office (312-332-0910 or email MATHOMPSON@FWCOOK.COM). Specific technical questions or questions relating to the applicability of these statements to specific company situations should be addressed to the appropriate professional counsel.

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