October 7, 1996

Transferable Stock Options--

After New Rule 16b-3

In recent years, many financial planners have been advising top executives to explore stock option transferability as part of their estate planning despite the potential pitfalls that existed. This technique allows executives, with little or no additional tax, to pass on stock or stock options that would have been in the estate and subject to estate taxes at rates up to 55 percent.

The recently effective changes to Securities and Exchange Commission (SEC) Rule 16b-3 eliminated the requirement that stock options and other derivative securities be non-transferable for the grant to be exempt from the short-swing profit recovery provision of Section 16(b). Now that this prohibition has been lifted, early indications are that there will be a rush to implement option transferability among corporations. Nearly all publicly held companies and many privately held ones grant stock options, and most of the issues surrounding the implementation of option transferability are clear. This piece will outline the key technical areas, and present guidelines that may be useful in adding this feature to a stock option program.

Key tax issues

The main objective of transferable options is to move the stock gained from the exercise of an option out of the executive's estate with the lowest possible tax impact. The gift tax, estate tax and income tax ramifications of transferable options may not be familiar even to expert compensation practitioners. The following paragraphs provide a high-level summary of the most relevant tax provisions that apply. The tax rules covering these situations are very complex, and professional advice should be sought on the specifics of any company program.

Estate taxes--At the time an estate is passed on, the stock or cash from options exercised during the executive's life is subject to estate tax at rates up to 55%. Any amount passed on to the spouse is tax free, but amounts passed on to other heirs are exempt from estate tax only up to a $600,000 exemption unless this limit has been reduced by lifetime gifts in excess of an annual exclusion of $10,000 per individual recipient ($20,000 if joint gift). The tax credit based on this $600,000 is referred to as the Unified Tax Credit. In many cases, the value of stock from option exercises in a senior executive's estate will far exceed this limit. Transferring the option during the executive's lifetime allows the beneficiary to obtain the option proceeds without any reduction by estate taxes.

Gift taxes--Anyone can give away up to $10,000 ($20,000 if joint gift) per year to another

individual without triggering gift tax at the same rates that apply to estate taxes. If this limit is exceeded on any individual gift in any year, a gift tax return must be filed by the donor. To the extent that aggregate lifetime gifts have not exceeded the $600,000 exemption described above, no gift tax is due at the time of the gift, but the $600,000 exemption is reduced by the gift amount over the $10,000/20,000 annual gift exclusion. To the extent that a gift exceeds the $10,000/20,000 annual exclusion and the $600,000 lifetime exemption has been exhausted, gift tax will be due in the year in which the gift is made.

Income taxes--No income taxes are due at the time of the option grant or at its transfer as a gift. As with any non-qualified option,**Footnote1** the gain on the option at the time of exercise (difference between strike price and market price on the date of exercise) is income subject to tax. The income from the exercise is attributed to the executive, not the recipient of the option. Accordingly, all income tax must be paid by the executive.

The table below summarizes the applicability of these taxes at different stages:

	Option Grant	Option Gift	Option Exercise**	Estate Transfer
Income Tax				
Executive	None	None	Responsible for all tax withholding	--
Recipient	None	None	None	--
Gift Tax				
Executive	--	Yes, on present value of option*	None	--
Recipient	--	--	--	--
Estate Tax				
Executive (Estate)	--	--	--	None
Recipient	--	--	--	--
*Subject to the $10,000 ($20,000 if joint gift) annual exclusion from gift tax $600,000 lifetime Unified Gift/Estate Tax exemption may be applicable				
** Exercise occurs at the discretion of the recipient				

How does it work?

Conceptually, the mechanics of option transferability are simple to understand.

- A non-qualified option, which hopefully is less valuable early in its term, is irrevocably gifted to a family member and continues to be subject to the same provisions as if the executive retained possession; there are no income tax ramifications until the option is exercised;**Footnote2** the fair market value of the option on the date of the gift is subject to gift tax; if this value is low, it may have minimal impact or escape gift tax altogether due to the annual gift exclusion and the Unified Tax Credit discussed earlier.
- The recipient elects when to exercise at a time when the option is presumably worth far more than it was at the time of the gift.**Footnote3**
- Income is attributed to the executive at the time the recipient exercises the option; the executive is responsible for all income tax, including withholding.
- The recipient now owns the stock, having paid no tax. The executive is in exactly the same income tax position as if the gift had never taken place (other than any gift taxes that may have been applicable when the gift was made).

What makes transferable options work?

Two things make it work.

- First, the value of the option early in its life can be a fraction of what it might eventually be worth. If gifted before any meaningful gain (difference between strike price and current market price) exists, it is not uncommon for financial advisors using the Black-Scholes option pricing model to determine a value of less than 20% of the option's strike price after considering the limitations on vesting and transferability.
- Second, the estates of many senior executives today are many multiples of the $600,000 exemption for estate tax purposes, and any stock derived from option exercises will almost certainly be subject to estate taxes unless transferred or gifted prior to death.

Because of the interaction of these factors, many estate planners are convincing top executives that this approach is worth considering.

What are the potential pitfalls?

Several key issues need to be considered in deciding to implement option transferability:

- How will the option be valued at the time of the gift?--Up until recently, debate raged

on the valuation of options for accounting purposes. Financial Accounting Standards (FAS) 123 may have ended the debate, and provides strong support for using the Black-Scholes approach to determine the value of the option for gift purposes. Financial advisors may recommend additional "haircuts" in the value to reflect the vesting and transferability limitations that apply.

- How many executives should be able to utilize this feature?--While there is no cost to the company for extending this to as many executives as possible, the conservative approach will likely win out in the early years. One factor to be considered is that the executive must be in a position to settle any tax withholding requirements at the time the recipient exercises the option. Reasonable scenarios include covering only executive officers, providing it to all senior executives, offering the feature to those who participate in the financial counseling program, or utilizing the same salary or compensation cutoffs that determine whether compensation actions need approval by the compensation committee.
- To whom should the executive be able to transfer the option?--It is reasonable to limit option transferability solely to gifts to immediate family members. This retains the strong linkage between the character of the option as an incentive award under the presumption that executives are as interested in maximizing their families' wealth as their own and minimizes the judgment calls that will need to be made about the appropriateness of the transaction.
- How will transferring options affect the incentive power of the grant?--Top executives have for years been diversifying their company stock portfolios through gifts to family members, and establishing trusts for that purpose as well. Logic seems to argue that the option could be seen to be simply another stock-related asset in the executive's portfolio, and the motivational impact of that in a family member's hands is no different than in the executive's hands.
- Once an option has been transferred by a named executive officer shown in the company's proxy statement, what is the required disclosure?--To our knowledge, the SEC has not provided any guidance on this issue. We think that if the option is transferred for consideration, the value received should be reported as though it were a gain upon exercise for the year in which the transfer occurs. However, we expect that most transfers will be limited to gifts to immediate family members (no consideration received). In these situations, a company might continue to report the transferred option in the outstanding options table, but perhaps as a separate line item with an appropriate explanation in the accompanying text or a footnote. This would be consistent with inclusion in the beneficial ownership table.

"Nine-step program" for successfully implementing transferable executive stock options

The following guidelines will serve to assist compensation professionals in successfully incorporating a transferable feature.

1. Educate and obtain approval of the Compensation Committee--as with any change in mindset, explaining the rationale for this move requires selling the ability to retain the incentive character of the grant along with the financial benefit to the executive without any corresponding cost to the company
2. Revise existing grant agreements and shareholder-approved plans--while some recently approved plans provide for possible transferability if permitted by Rule 16b-3, most plans include language absolutely prohibiting transferability; this change most likely will not require shareholder approval, depending on the provisions of the existing plan; grant agreements may also contain provisions prohibiting transfer except in the case of death
3. Limit transferability to gifts to immediate family members, or trusts or other legal structures representing immediate family members--to protect the incentive value of the grant, transfer should be limited to those most likely to be beneficiaries of the executive's estate; transferred options should no longer be transferable once in the hands of the family member
4. Limit the extension of the transferable feature to the most senior executives--these executives are likely those who are most attuned to corporate strategy and shareholder value creation, and are also those with the most significant grant sizes and the largest estates; while other executives at lower levels in the organization might be able to benefit from this feature, other estate planning techniques will effectively address most of their needs
5. Revise outstanding grants to incorporate the transferability feature--the positive impact of doing this suggests that it should be available for all outstanding non-qualified options (extending transferability to ISOs disqualifies them from ISO status); the IRS has ruled privately that amending the plan or retroactively applying transferability does not affect the performance-based character of the stock option for Internal Revenue Code §162(m) purposes (the $1 million deductibility cap);**Footnote4** we are aware that at least one major accounting firm has taken the position that amending an outstanding option grant to allow transferability will not trigger a charge to earnings
6. Obtain legal and tax advice concerning
    - the appropriate registration of securities offering obtained by the recipient of the option; unless the SEC changes the current rules and allows the use of the Form S-8, the current alternatives include relying on SEC Rule 144 or filing under Form

- the gift and estate tax consequences of transferring an unvested option, if applicable; two key concepts are involved:

  first, whether a "completed" gift has been made; this issue hinges on whether the executive has parted with dominion and control over the option, and determines when the gift becomes taxable; private letter ruling 9616035 referenced earlier specifies that the gift of an option is a "completed" gift, and retains the terms under which it was granted; however, vesting was not specifically addressed in this ruling

  second, whether the gift is considered a "future interest" rather than a "present interest;" a gift is a "future interest" if the recipient's rights to the use, possession and enjoyment of the property and income from the property will not begin until some future date; a gift of a future interest cannot be excluded under the annual $10,000/$20,000 exclusion;**Footnote5**

  some recognized estate tax experts agree that vesting provisions do not jeopardize the classification of the gift as a "present interest" or as a "completed" gift; however, differences of opinion exist and appropriate professional advice should be sought

7. Ensure that administrative systems are appropriately structured to allow gifting portions of a single option to different family members, provide for exercise by a family member and incorporate a third party cashless exercise feature
8. Design clear communications materials providing an example of the potential estate tax benefits and reinforcing the incentive character of the grant and the consequences of the recipient neglecting to exercise the option prior to expiration
9. Continue to include any gifted grants in annual total compensation statements, reinforcing the incentive value of the grant along with the potential value to the executives (or their heirs); with appropriate footnotes, gifted options may also be included in the beneficial ownership table in the proxy statement

* * * * * * * *

With proper planning, the implementation of transferability features can provide significant additional estate planning flexibility for top executives with no additional cost to the company. Adopting this feature should be seriously considered by all companies with stock option plans.

This represents our understanding of the relevant securities and tax regulations. Detailed questions should be addressed to appropriate professional counsel. General questions may be addressed to Mike Thompson in our Chicago office, or any consultant in our firm. Copies of this letter and other published materials are available on our web site, WWW.FREDERICWCOOK.COM.

Footnote1

Incentive Stock Options (ISOs) must be non-transferable by their terms to qualify as ISOs

Footnote2

Internal Revenue Service (IRS) Private Letter Ruling (PLR) 9616035, January 23, 1996

Footnote3

Please note that, unless the SEC changes the current rules and allows the use of Form S-8, neither third party cashless exercise nor the immediate sale of option shares to fund the exercise is available unless. Form S-3 has been used to register the shares; see registration issues on page 6

Footnote4

Internal Revenue Service PLR 9551024, September 24, 1995

Footnote5

Internal Revenue Service Instructions for Form 709 (Revised November 1993)