USING OPTIONS TO ALLOW DONEES TO HAVE THE DONOR'S CAKE AND EAT IT, TOO

BY
LOUIS S. HARRISON[1]

Louis S. Harrison is the partner in charge of the trusts and estates group at Lord, Bissell & Brook, Chicago, Illinois.

TABLE OF CONTENTS

I. SELECTING ESTATE PLANNING TECHNIQUES
II. NON-QUALIFIED STOCK OPTIONS
III. SECURITIES AND EXCHANGE COMMISSION (SEC) REGULATIONS
IV. THE CORE OF THE STRATEGY
V. HOW TO VALUE OPTIONS FOR GIFT TAX PURPOSES
VI. RUDIMENTS OF OPTION PRICING METHODOLOGY
1. THE STOCK PAYS NO DIVIDENDS DURING THE OPTION'S LIFE
2. EUROPEAN EXERCISE TERMS ARE USED
3. MARKETS ARE EFFICIENT AND RETURNS ARE LOGNORMALLY DISTRIBUTED
4. NO COMMISSIONS ARE CHARGED
5. INTEREST RATES REMAIN CONSTANT AND KNOWN
VII. PREMISES IN THE MODEL ON WHICH TO FOCUS
VIII. REV. PROC. 98-34 REVISITED
IX. TO DISCOUNT OR NOT TO DISCOUNT: THAT IS THE QUESTION
X. WHO PAYS THE TAX AND WHEN?
XI. ANOTHER COMPLICATION: GIFT TAX COMPLETION
XII. POSTMORTEM INCOME TAX CONCERNS
XIII. CONCLUSION

I. Selecting Estate Planning Techniques

In gift and estate tax planning, sophisticated planning strategies are used to achieve different goals. For example, the family partnership is often used as a means to fragment value into various pieces, with the idea that the sum of the parts may be less than the whole.[2] Discounted pieces are then given away through lifetime gifting or testamentary transfers. Alternatively, the grantor-retained annuity trust is often used as a way for the donor to give away appreciation (at times, at discounted values) while obtaining a steady stream of payments.[3]

Planning with non-qualified stock options (hereinafter referred to, for the most part, simply as options) could, in the abstract, achieve certain goals of both a family limited partnership and a grantor-retained annuity trust, namely, transferring appre-

©1999 L.S. Harrison

ciation while reducing value for gift and estate tax purposes. In the abstract (not in reality, however), the transfer of an option valued at zero for book purposes (based on an intrinsic value method) could succeed in: (1) transferring appreciation to the donees; (2) incurring minimal gift tax cost at substantially discounted values for transfer tax purposes;[4] and (3) having the income tax being paid by the transferor (*i.e.*, the donor transferring the option).

As this transfer tax potential of options has been recognized by planners in recent years,[5] the taxation of these options has not gone without Internal Revenue Service (IRS) scrutiny. The IRS has focused and posited on important aspects of these options, including: (1) the party responsible for, and timing of, the income tax; (2) the completion of the gift for gift tax purposes, and, most importantly; (3) the valuation methodology of these options for gift tax purposes.[6]

The purpose of this article is to explore the continued viability of the use of options for gift and estate planning purposes within the framework of this IRS scrutiny.

II. Non-qualified Stock Options

Estate planning practitioners have not always focused on the importance of options in developing estate plans. However, the overall current worth of these options cannot be ignored. The value of unexercised compensatory stock options at the 800 most substantial publicly traded firms was recently estimated at 11 billion.[7]

There are two types of options commonly used in compensation programs. One is the incentive stock option, providing tax benefits under Code Sec. 422. The other is the non-qualified stock option.[8]

Incentive stock options are required to be non-transferable.[9] Accordingly, non-qualifying options granted to employees are relevant to an estate planning strategy that focuses on lifetime gifting.

Those options are usually open for a period of years; a typical option period is open for 10 years,[10] and the option can be exercised at any time during this period after vesting. Non-qualified options can either be exercisable at a price approaching the market value at the time the option is granted or at a discounted value.[11] Vesting often occurs over a period of time.[12]

The holders of non-qualified stock options are not taxed until the options are exercised and, accordingly, taxation can be postponed for as long as the optionee holds the option, rather than exercises it.[13]

Not all plans allow options to be transferred to family members. However, as options are becoming more popular for estate planning purposes, the transferability of these options by a company amending its plans is becoming more frequent.

III. Securities and Exchange Commission (SEC) Regulations

Prior to 1996, to qualify for the exemptions provided by Rule 16b-3 of the SEC regulations, stock options granted to directors and officers had to be non-transferable.[14] In 1996, the SEC amended Rule 16b-3 so that non-transferability was no longer a precondition of qualifying for the exception under that Rule.[15] Accordingly, the transferability of non-qualifying options has become more accessible.[16]

IV. The Core of the Strategy

Reducing the strategy to its basics, the gifting of non-qualifying options makes most sense if all of the following cylinders are in operation: (1) the gift tax value of the option, X, is less than its ultimate value, Y, discounted to present value; (2) the income tax on the exercise of the option is paid by the original optionee, and not by the recipient of the gift; and (3) the option is exercised.

Accordingly, under one analysis, the gifting of an option should be compared with the gifting of cash. For example, assume the client has call options for 100,000 shares of Duplex stock currently worth $100 per share, exercisable at $100 per share and open for one year. The Black-Scholes formula yields a price for the option of $8.595[17] per share, or $859,000 for all 100,000 shares. The same client has cash of $859,000.

If the cash is gifted, at the end of the year, the donee has $859,000 plus a return of, say, 5 percent after tax: $859,000 + $42,950 or $901,950.

The gift of the option is more delicate. If the stock value declines in the one-year period, the option will not be exercised and the gift *was* disastrous. If the option expires in the money, the then-fair market value of the shares is greater than the price at which the option must be exercised, and a different result occurs.

If the stock increases at a rate equal to its volatility used in valuing the option,[18] that increase—$15 x 100,000 shares, or $1,500,000—belongs to the donees, as a gift of only $859,000. Further, if the income tax can be allocated to the donor (the original optionee) substantial transfer tax efficacy is achieved.[19]

This example demonstrates the upside potential of an option gift. But because the option may expire out of the money, the gift tax value has a tremendous impact on its viability.

For example, in the prior example, 100,000 shares of Duplex stock worth $100 per share had options exercisable at $100 per share. Assume that the option continues for a longer period of time, that its Black-Scholes value, with discounts, for each option is $25 per share. Compare the gift of the options—100,000 shares x $25 per share—with an equivalent gift of an equal value of shares, purchased on a long position, 25,000 shares.[20] A stock price increase at the end of the option period of 100 percent[21] means the options yield $200 times 100,000 shares, less the strike price of $10,000,000, or $10,000,000. In comparison, 25,000 shares at $200 per share yields $2,500,000.[22] This is a tremendous upside for the options alternative.

However, no appreciation means the options expire outside of the money. The pure stock gift is still worth up to $5,000,000. This is a substantial downside for the options alternative.

At which point is the option gift too risky? The lower the initial gift tax value of the stock in relation to its face value, the less relative risk involved. Accordingly, valuation is pivotal.[23]

V. How to Value Options for Gift Tax Purposes

In Rev. Proc. 98-34,[24] the IRS set forth accepted methodology to value non-qualified stock options to purchase publicly traded stock for gift, estate and generation-skipping transfer tax purposes. Although the revenue procedure is not expressly tailored as a "safe harbor," it reaches that result by implication. The first line indicates that the revenue procedure sets forth "a methodology" to value options, thus connoting non-exclusivity and haven status.

In this regard, the concept of a safe harbor does not imply exclusivity. As discussed, alternative valuation methodology may still be appropriate and is useful in this area.

In Rev. Proc. 98-34, the IRS directly referenced FAS (Financial Accounting Standards) 123 in valuing options. FAS 123 allows "fair value" to be approximated by using the Black-Scholes model or a binomial model. Importantly, the practitioner need not walk blindly down the Black-Scholes or binomial path. FAS 123 requires publicly traded entities to disclose the method and significant assumptions used by the company to estimate fair value as set forth on its financial statements.[25] The question remains, however, whether this methodology is acceptable in an option gifting strategy.

VI. Rudiments of Option Pricing Methodology

The two widely accepted option pricing models noted in Rev. Proc. 98-34 are Black-Scholes and a binomial pricing tree. The Black-Scholes concept is based on a hedged portfolio, consisting of shares of the underlying stock and riskless zero-coupon bonds.[26] The binomial model has been described as "the most versatile and widely used model for stock price movements and for options pricing."[27]

Under either theory, an understanding of the underlying assumptions is essential to the valuation strategies. As author Neil Chrissis points out:

> If we want to use the Black-Scholes formula to compute option values and nothing more, then there is nothing much to discuss. However, the interesting and important part of option pricing theory is understanding intuitively what makes it tick. This leads to important insights into risks and hedging costs.[28]

For the estate planning practitioner, an understanding of each model is important. Black-Scholes illustrates this point. The formula for the Black-Scholes model is shown in Figure 1.

The first part of the formula, $SN(d_1)$, projects the anticipated benefit from acquiring a stock outright. The second part of the formula, $Ke^{(rt)}N(d_2)$, gives the present value of paying the exercise price on the expiration day. The fair market value of the call option is then calculated by taking the difference between these two parts.

The model is based on several assumptions. Before describing the characteristics of the model, note that it is only a "model," based on probability analysis. It is pliable and imprecise as a result.

1. The stock pays no dividends during the options life. Most companies pay dividends to their shareholders. Higher dividend

FIGURE 1

$C = SN(d_1) - Ke^{(rt)} N(d_2)$	
C = option price	e = exponential function (2.7183)
S = current stock price	$d_1 = \frac{\ln(S/K) + (r + o^2/2)(t)}{o\ t}$
t = time until option expiration	$d_2 = d_1 - o\ t$
K = option striking price	o = standard deviation of stock returns
r = risk-free interest rate	ln = natural logarithm
N = cumulative standard normal distribution	

yields result in lower call premiums. To adjust the model for this situation, the appraiser should subtract the discounted value of future dividends from the stock price, thereby lowering the option value.

2. European exercise terms are used. European exercise terms dictate that the option can only be exercised on the expiration date. American exercise terms allow the option to be exercised at any time during the life of the option, creating more value to American options. However, with non-qualified options and limited transferability and vesting concerns, they look more like European call options.

3. Markets are efficient and returns are lognormally distributed. This assumption suggests that people can consistently predict the direction of the market or an individual stock. The market would then operate continuously with share prices following a continuous Ito process. However, markets do not follow "a random walk in continuous time with a variance rate proportional to the square of the stock price."[29] Greater variance increases stock price.

4. No commissions are charged. Usually market participants do have to pay a commission to sell options. The fees that investors pay can distort the Black-Scholes valuation.

5. Interest rates remain constant and known. The Black-Scholes model uses the risk-free rate to represent this constant and known rate. In reality, there is no such thing as the risk-free rate, but the discount rate on U.S. Government Treasury Bills with 30 days left until maturity is usually used to represent it. In today's rate environment, these 30-day rates are not often subject to great change, thereby keeping with one of the assumptions of the model. Lower discount rates lead to lower option values.

VII. Premises in the Model on Which to Focus

In a perfect world, an estate planning professional would know the interplay and effect of these variables on the value of options. In the real world, the professionals rely on other professionals, or on business or stock appraisers, for this insight. This outline explores a middle ground, focusing on the most important of the previously discussed variables of option pricing.

One variable is volatility, defined to be the measure of the amount and rate of price fluctuation.[30] For example, highly volatile stocks tend to have greater price fluctuations. Increases in volatility, such as from 15 percent to 16 percent, increase the call options price.[31] Intuitively, this makes sense. An option is only valuable if it expires in the money. Highly volatile stocks, though they may have tremendous downside risk, also have analogous upside potential. As the extent of the downside risk is of no import, the greater upside risk means greater value.[32] In gifting transactions, the goal is to therefor lower the volatility variable.

A second variable is the time to maturity. As the time variable increases, an option's value changes even if the stock value remains the same. The value of an option decreases as the time moves closer to its expiration. Accordingly, accurately calculating the option's true expected life is essential. Although Rev. Proc. 98-34 prescribes methodology,[33] this should be reviewed closely for arguments to shorten the period.

A third variable in the formula is the risk-free interest rate. As interest rates increase, the value of the option rises.[34]

VIII. Rev. Proc. 98-34 Revisited

A number of guidelines are set forth in Rev. Proc. 98-34. The IRS goes into detail in preventing too many iterations on the variables

discussed in the preceding section. Specifically, the procedures provide guidelines:

1. In circumscribing the computed expected life factor and describing when the maximum remaining term must be used in lieu of the computed expected life factor;
2. In fixing the volatility number and expected dividends to those disclosed in the financial statements; and
3. In tying the factor for the risk-free interest rate to that of zero-coupon U.S. Treasury Bonds.[35]

IX. To Discount or Not to Discount: That Is the Question

Rev. Proc. 98-34 creates the most difficulty by noting that no discount can be applied to the valuation produced by the option pricing model. For example, no discount can be taken due to lack of transferability or due to the termination of the option within the specified number of days following termination of employment. This preclusion is crucial, especially if it is correct.[36]

This prohibition against discounts cuts at the heart of the methodology. Black-Scholes and binomial models focus on options that are publicly traded. Those models do not necessarily approximate value when dealing with options that have limited transferability.

In their excellent article, *Considerations in Valuing Stock Options*, the authors, Carl F. Luft, Lawrence Levine and Jon Howe, make the point that when prices for options which are freely traded in the public market are compared to prices from stock options that have transferability restrictions, the evidence indicates "that the value of a stock option traded in a non-liquid market is substantially lower than the option's theoretical value."[37] The authors contend, based on their empirical evidence, that relying on methodology such as Black-Scholes results in overvaluation because that model does not reduce value based on illiquidity.[38] The article indicates that the valuation reduction for thinly traded options ranges from 22 percent to 45 percent (for options with transferability restrictions).[39]

The discounting concept is perhaps no more than a restatement of the proper methodology for valuation. Black-Scholes, for example, is a valuation methodology based on hedging options with risk-free investments over a short period of time. It presupposes that the options are transferable during this time. This does not match up very well with options that have vesting requirements and transferability restrictions, and that are open for a long period of time.

Perhaps more approximate of the value of options would be to take the current market value of the stock, reduce it by the discounted fair market value of the option price using the risk-free interest rate (through date of expected exercise), and reduce it further by the discounted present value of the expected dividend stream.[40]

For the practitioner, the strategies to consider in light of Rev. Proc. 98-34 are as follows:

1. The safe harbor guidelines could be followed and relied upon. In this regard, determine if the company publishes the value of its options in its financial statements. If yes, then review how the variables are listed.[41] A price per gifted option that is based on variables lower than the published variables in the financial statements must be justified. For example, volatility may be a constant, and will be noted in the financials. If no materials are published, more iterations of that variable are possible. The life expectancy of the option is an important component in the equation. Rev. Proc. 98-34 allows the taxpayer to occasionally factor in the weighted average expected life of the option disclosed in the financials, which is usually on the low end.[42] Arguably, a shorter expected life can approximate a discount based on non-transferability, but this is only a partial mitigation. The revenue procedure prescribes typically that the "maximum remaining term" be used.[43]

2. The safe harbor could be ignored and an independent appraisal could be obtained. Based on the Luft data,[44] independent appraisals may provide substantial evidence of reductions from the value obtained pursuant to the prescribed methodology. If a gift tax return is filed, the statute of limitations period—three years from filing—will begin running.[45] The filed return will *not* indicate it is being filed pursuant to Rev. Proc. 98-34. Other than interest (penalties are unlikely with an actual appraisal), this strategy would put the client in a win-tie position versus use of the safe harbor procedure. This strategy is preferable to the first strategy.

3. The assumptions underlying the revenue procedure methodology could be adjusted. For example, the methodology provides that no discount can be taken for lack of transferability or termination prior to vesting. This part of the revenue procedure does not seem justified. An aggressive strategy would be to ignore that part

of the revenue procedure and have the business appraiser discount the shares regardless, and then file pursuant to Rev. Proc. 98-34. This is sort of a one-foot-in, one-foot-out approach. The second approach seems more internally consistent.

4. The options could be transferred to fund a family limited partnership, at an undiscounted value, followed by a gift (or sale) of discounted family limited partnership interests.[46] The income tax implications of the initial funding are interesting and uncertain. Triggering income recognition under Code Sec. 721 can and should be avoided. Is the initial contribution a deemed disposition under Code Sec. 83? IRS Letter Ruling 9830036 says no, in a fairly direct way. However, that statement was more in dicta than part of the ruling. An examination of Code Sec. 83 and Reg. §1.83-7 leads one to conclude reasonably that transferring options to a partnership could be a triggering event under Code Sec. 83. If so, that may not be a disastrous result.[47]

The partnership will be organized with two types of equity interests: general partnership interests and limited partnership interests. General partnership interests will be entitled to control partnership decisions, specifically, to elect managing partners. The managing partners decide on partnership distributions, such as when and if to make these. The general partners decide whether to liquidate the partnership, sell assets or merge the partnership with a third party. In these ways, the general partners control the partnership. The limited partners are entitled merely to distributions from the partnership, when made. These could be yearly distributions, or they could be distributed more sporadically or upon sale or other liquidation. The majority of the equity is represented by the limited partnership interests. For example, 90 percent of the equity in the partnership could be represented by limited partnership interests. The minority of the equity is represented by the general partnership interests, typically less than 10 percent. In that scenario, parents can set up a limited partnership by contributing 90 percent of the equity (options) to the partnership. The parents can thereafter give a part or all of their limited partnership interests, arguably valued at a discount, either outright or pursuant to annual exclusion gifting formats, or to grantor retained annuity trusts or Code Sec. 2701 partnerships. Perhaps the parents could sell these interests in some type of installment sale or outright fashion.[48]

X. Who Pays the Tax and When?

The income tax consequences of the option is the second engine that motors the transaction. If the donee of the option must pay the income tax associated with the deferred gain, the gifting value of the transaction is substantially lessened.[49] Also, the transfer of the option from the original optionee to the donee should not be a taxable event for the strategy to work. Positive conclusions have been supported by the IRS, and the answers are found in the Internal Revenue Code and regulations.

Initially, the granting of a non-qualified option should not be a taxable event. Code Sec. 83 generally treats property received in exchange for services as compensation. However, that Code section does not apply to property that does not have a readily ascertainable fair market value at the time of the grant.[50]

An option will have a readily ascertainable fair market value only if: (1) it is actively traded on an established securities market; or (2) it satisfies all of the following elements:

- The option is transferrable by the optionee;
- The option is exercisable immediately in full by the optionee;
- The option is not subject to any restriction or condition which has a significant effect on the fair market value of the option; and
- The option privilege has a readily ascertainable fair market value.[51]

Typically, stock options granted to executives under employer-sponsored stock option plans are not actively traded on an established market because the optionee only has a narrow right to transfer. The requirement of the second tier that "the option is transferrable by the optionee" is not satisfied.[52]

Alternatively, allowing an employee only narrow transferability should have a significant effect on the fair market value of the option, within the meaning of the third condition above. Interestingly, in light of Rev. Proc. 98-34, the IRS is implicitly concluding that these options do have a "readily ascertainable fair market value."[53]

Also, the transfer of a stock option to a family member as a gift without receiving consideration should not result in the recognition of income upon the transfer.[54]

Importantly, Code Sec. 83 continues to apply to the option. The income that is recognized when the stock option is exercised is the difference between the exercise price and the stock's fair market value. This is treated as ordinary income under Code Sec. 83.[55]

Under a typical construction of Code Sec. 83, income should be recognized by the employee when the option is exercised.[56] The income tax would then fall on the individual who received the option as compensation. Like the grantor trust area,[57] the payment of the income tax should not result in the taxable gift by the owner of the option to the donee. The income tax essentially increases the basis of the stock in the hands of the transferee.

IRS Letter Ruling 9830036 substantiates many of these issues. For example, it provides that Code Sec. 83 will not apply to an option which is transferable only to permitted transferees, defined as essentially family members or trusts or partnerships for their benefit.[58] Transfer to a permitted transferee also will not cause the optionee to recognize taxable income or gain at the time of the transfer under Reg. §1.83-7(a).

Further, if the permitted transferee subsequently exercises an option, the optionee will recognize taxable income at the time in an amount equal to the excess of the fair market value of the common shares received by the permitted transferee on exercise over the option price paid for the common shares. The permitted transferee's tax basis will be equal to the fair market value on the date of exercise (this consists of both the option price plus the amount of income recognized by the optionee under Code Sec. 83(a).[59]

XI. Another Complication: Gift Tax Completion

Options are often subject to vesting requirements. For example, the optionee may not be vested in granted options unless the optionee remains in the company's employ for at least a year after the grant of an option. The vesting requirement, if properly applied for gift tax purposes, provides three benefits: first, it should result in a built-in discount in valuation because the options may be lost; second, the stock value is fixed at the time of grant (and, therefore, the option value is fixed as well); and, third, the initial term of the option is reduced by the non-vested time period.

For purpose of the gift tax regulations, specifically Reg. §25.2511-2(b), a completed gift is made when the grantor relinquishes control over assets.[60] The issue that now comes into play is whether the gift of a non-vested option is a completed gift. Prior to 1997, one would have expected the answer to be yes.

But in Rev. Rul. 98-21,[61] the IRS has tried to curtail further the benefits of transferring options. It ruled that until an employee had performed all services required as a precondition to exercising the option, the option is not yet a binding and enforceable property right. Simply, the transfer of a non-vested option is not a completed gift. The option is considered a completed gift upon the later of the date of transfer or the time when the donee's right to exercise the option becomes vested.

In a rising stock market, delaying the time at which a gift is complete could increase the value of the option, thereby increasing the transfer tax cost of making a gift. It certainly creates uncertainty and administrative difficulty in planning for the option.

The better result is that not only are these options completed gifts, but that they have or are entitled to discounts in valuation because they are dependent on the completion of services before they vest. Rev. Rul. 98-21 is bizarre in its holding on the donor's retained "dominion and control." The only control which the donor retains is through termination of employment before the option fully vests.

For comparison, in Rev. Rul. 84-130,[62] the IRS noted that a power exercisable only as a result of a potentially costly related action—termination of employment—is not a retained right. This was in the Code Sec. 2042 context. It concluded that the right to terminate employment is an act of independent significance.[63]

Further, the IRS cited Rev. Rul. 80-186[64] for the language that the option had to be "binding and enforceable under state law on the date of the transfer." And yet, an unvested option is still a binding and enforceable right, albeit subject to divestment if something (employment) does not continue to happen. Here, it looks like a contingent remainder interest, which can be the subject of a completed gift (*e.g.*, Code Sec. 2702 dealing with personal residence trusts).

The following planning strategies should be considered:

1. Conclude that Rev. Rul. 98-21 is wrong and inconsistent with prior IRS pronouncements (and ignore the ruling for gifting purposes).
2. Gift only vested options (avoid staged-in options).
3. Gift the option along with an enforceable guarantee if vesting does not occur. Alternatively, convince the company that in lieu of vesting requirements, it should build in non-transferability restrictions if options are exercised.[65]

XII. Postmortem Income Tax Concerns

If the option is not exercised during life, it would seem that the original option holder's estate would remain responsible for the taxable income equal to the unexercised spread. In IRS Letter Ruling 9616035, the IRS noted that if the taxpayer is not living when the donee of the option exercises the option, the decedent's estate will be deemed to have received the Code Sec. 83 ordinary income. This would mean that the income tax liability would be borne by beneficiaries receiving the benefits of the estate. The recipient of the option would receive, in effect, a basis step up.

In contrast, Reg. §1.83-1(d) implies that unexercised options should be treated like other income in respect to a decedent under Code Sec. 691(c). However, Code Sec. 691 applies to property owned by the decedent at death. If the decedent does not own such property, an argument can be made that it should not be considered as income in respect to a decedent.

Until there is more on this issue, the better result from a tax perspective is to tax the estate on the inherent income tax. The result from an estate tax perspective is not clear. The inherent income tax liability is a debt. Its value is as follows: (X + Y) x P, where X is the unexercised spread at death, Y is the discounted present value amount of any increase or decrease from X from date of death through expiration (or exercise), and P is the probability that the option will be exercised.

This is an enforceable obligation of the decedent's estate. It looks, acts and smells like a deductible debt under Code Sec. 2053(a)(4). However, Code Sec. 2053(c)(2) provides a roadblock. It literally provides:

> Any income taxes on income received after the death of the decedent . . . shall not be deductible under this section.

At first glance, that Code section clearly applies to prevent the deduction, but does (should) it? That phrase coordinates with the Code Sec. 691(c) deduction, so that income in respect of a decedent does not receive deductibility under two sections of the Code. Further, that Code section was intended to preclude deductibility for income earned by estate assets postmortem, since that income was not an estate asset included on the estate tax return. But the Code Sec. 83 option income tax is not within the reasoning of either policy argument. A policy argument for deductibility is appealing. However, the current Code language does not permit it.

XIII. Conclusion

To sum up option planning in light of the recent IRS pronouncements (a euphemistic substitution for the word "roadblocks"):

1. Aggressive and, more importantly, realistic option valuations should be obtained from independent appraisers. Rigid adherence to Rev. Proc. 98-34 is not justified. The safe harbor value of this revenue procedure is not deserving of great import, unless options are coupled with a family partnership strategy.
2. In contrast, safety justifies gifting of only vested options, if possible.
3. Income tax benefits are conservatively maximized if the options are exercised prior to death.
4. The use of options and family limited partnerships should be considered.

ENDNOTES

[1] The author gratefully acknowledges the insights of John Hughes, Rob Held and Kerry Vyberberg, of Lord, Bissell and Brook, Holly Isdale and Beth Clark Rodriguez, of JP Morgan, Inc., and Professor Dana Northcut, of the University of Chicago GSB, in preparing and developing this article.

[2] See, e.g., Hamill and Stout, *Valuation Discounts for Intrafamily Transfers*, 59 TAX'N ACCT. 75 (1997).

[3] See, e.g., Newlin and Andrey, *Structuring GRATs under Section 7520 Regulations*, 24 EST. PLAN. 156 (1997).

[4] The restrictive terms of options, such as vesting over a period of time and limited transferability, should adversely affect such values. For example, if an executive is granted an option for 10,000 shares with a 10-year term, to purchase the stock at $100 per share, consider its value for gift tax purposes under the application of Black-Scholes. See Black and Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973). Under Black-Scholes, a formula is used to determine the valuation. Assume the formula results in value equal to 50 percent of the underlying stock value. The 10,000 shares at $100 per share are valued at $1,000,000 times 50 percent, or $500,000. This means that a third party would pay $500,000 to have the right to exercise an option that, if exercised on day one of the purchase, would yield no money to the purchaser. The right to exercise the option terminates in 10 years. The right cannot be exercised immediately because it is not vested. The right cannot be transferred to a third party because the option agreement prohibits it. Although the stock market performance over the last four years may militate in favor of this not being a bad economic transaction for the purchaser, a reasonable third party may still conclude that $500,000 is substantially more than this option is really worth. Accordingly, one may reasonably conclude that a third party would give a greater than 50-percent reduction for the option because of the risk of forfeiture, lack of transferability to non-family members, limitations on exercise, and

ENDNOTES

noncontinual growth potential of the option. At a 75-percent reduction, the options would be worth $125,000. This seems more justifiable, albeit aggressive on its surface. The gift tax viability of a transfer at $125,000 is substantial. See *infra*, "How to Value Options for Gift Tax Purposes." However, Rev. Proc. 98-34, 1998 IRB. 1998-18, 15, disallows discounts on valuation, discussed *infra*.

[5] Corresponding, not coincidentally, with the substantial growth in the stock market.

[6] The most recent IRS missives are Rev. Proc. 98-34, *supra* note 4, and Rev. Rul. 98-21, IRB 1998-18, 7, discussed *infra*.

[7] *See Stock Options Are Not a Free Lunch,* FORBES (May 18, 1998), at 51, a controversial piece in other regards. Total value of shares set aside for option grants was recently estimated at $600 billion. J. Fox, *The Next Best Thing to Free Money,* FORTUNE (June 7, 1997), criticized soon thereafter in the Wall Street Journal.

[8] Defined by implication to mean an option not qualifying under Code Sec. 422.

[9] Code Sec. 422(b)(5).

[10] Exercise during the term is in contrast to non-U.S. options, which are exercisable typically only at certain times, such as at the end of the period.

[11] Discounted stock options have an exercise price which is less than the market value of the option stock on the date the options are granted.

[12] Options are often structured with other features. *See* Morgan and Luepker, *Transferable Stock Options,* 24 TAX MGMT. COMP. PLAN J. 215 (1996) (discussing other features, such as a requirement to hold the stock after the option is exercised, restrictions on selling shares after exercise because of securities laws, and reload features granting new options after old ones are exercised).

[13] *See infra,* "Who Pays the Tax and When."

[14] If an option falls under Rule 16b-3, the granting itself of the option does not constitute insider trading.

[15] 17 CFR 240.16b-3.

[16] In March 1998, the SEC issued proposed regulations to amend Form S-8 to facilitate the exercise of stock options by family members who are given non-qualifying options by an employee. *See* Release No. 33-7506. This would extend Form S-8 to non-employee option transferees. Until the proposed regulations are finalized, non-employee optionees must rely on the company filing Form S-3, which may be administratively cumbersome for the company. Failure to file Form S-3 means that the stock could be restricted on the exercise of an option, perhaps arguing for a further discount in valuation. *See infra,* "To Discount or Not to Discount: That Is the Question."

[17] *See infra,* discussion and formula under "Rudiments of Option Pricing Methodology." This example assumes volatility of 15 percent per year and a risk-free rate of interest at five percent.

[18] 15 percent, the assumption used in note 17.

[19] *See infra,* "Who Pays the Tax and When?"

[20] 25,000 shares x $100 per share is $2,500,000; 100,000 options at $25 per option is $2,500,000.

[21] $100 per share increased by 100 percent yields a price per share of $200.

[22] 25,000 x $200 - $2,500,000, which is less then $20,000,000 minus $10,000,000.

[23] There is no precise formula on when the upside outweighs the riskiness of a decline. However, the lower the value, the greater the gift tax leverage.

[24] IRB 1998 -18, 15.

[25] This will provide a ceiling guideline. Keep in mind that companies would prefer lower valuations on unexercised options for a variety of reasons, including non-dilution of analyst adjusted earnings per share. Therefore, to the extent possible, a company is likely to use favorable variables for its Black-Scholes analysis. *See* discussion *infra*.

[26] Riskless in this sense means "less risk."

[27] NEIL CHRISSIS, BLACK-SCHOLES AND BEYOND (McGraw-Hill, 1997), at 219.

[28] *Id.* at 142.

[29] *Id.* at 640. Stock prices being *normally* distributed has not been supported by empirical evidence. *Id.* at 115.

[30] *Id.* at 95. Defined usually by sigma. One commentator indicates that for companies with general price volatility, 10-year options with an average dividend yield, a Black-Scholes option value is typically 33 percent of the price of the option stock on the date of the grant. Silverstein and Mullins, *Use of Non-qualified Stock Options for Qualified Plans, Compensation and Estate Planning,* AMERICAN BAR ASSOCIATION CENTER FOR CONTINUING LEGAL EDUCATION IN THE NATIONAL INSTITUTE, November 6-7, 1997.

[31] *Id.* at 163. The author defines the formula as 30.30 times the increase in volatility. This is often referred to as vega.

[32] *See, e.g.,* Ciccotello, *Employee Stock Option Accounting Changes,* 1-88 JOURNAL OF ACCT'CY 72 (1995).

[33] *See infra,* "To Discount or Not to Discount: That Is the Queston."

[34] CHRISSIS, *supra* note 27, at 178.

[35] To make sure practitioners follow this methodology, the revenue procedure sets forth filing procedures to alert the IRS as to the transfer and valuation methodology of the options.

[36] Note that Code Sec. 83 does not apply to the initial grant of the options because the IRS has accepted that these options are subject to restrictions that make their value not subject to reasonable ascertainment. There is inherent inconsistency in the IRS's Code Sec. 83 position and its non-discount requirement in Rev. Proc. 98-34.

[37] *Valuation Strategy* (May/June 1998) at 15.

[38] *Id.* at 16.

[39] *Id.* at 15.

[40] This is known as the "minimum value" method recognized by the FASB. FAS 123 allows minimum value to be used in valuing stock options for a nonpublic company. *See also Two Option Pricing Models,* 8-88 J.A. 68 (1988).

[41] For example, Delta Air Lines, Inc.'s (NYSE: DAL) 1997 financials, note 14, provides the following information: number of shares subject to option, exercise price equal to price at time of grant, generally vesting one year after date of grant and exercisable at any time up to 10 years, non-transferable other than at death, weighted average remaining life, use of Black-Scholes pricing model, risk-free interest rate at six percent, per share dividend, and 2.7-year expected life of option.

[42] The formula is the weighted average disclosed in the financials multiplied by the maximum remaining term after vesting, divided by the number of years the option can continue, computed as of the time the option was granted. There are exceptions that modify this "beneficial" (perhaps "non-detrimental" is a better word) rule.

[43] For example, if any of seven conditions are met, including non-termination of options within six months of discontinuation of employment.

[44] *Supra* note 37.

[45] Code Sec. 6501.

[46] *See* CCH IRS LETTER RULINGS REPORT NO. 1049, April 9, 1997, LTR 9714012 (Dec. 26, 1996), impliedly allowing the transfer of an option to a family partnership, and CCH IRS LETTER RULINGS REPORT NO. 1117, July 29, 1998, LTR 9830036 (April 29, 1998), which is more direct in that conclusion.

[47] If the option is gifted soon after it is granted, prior to appreciation (or any substantial appreciation), then the income realized will be minimal. Thereafter, ordinary income will be turned into capital gain. The donee of the limited partnership could be a grantor trust as to the original option holder. Any real-

ENDNOTES

ized gain would then be taxed back to the holder under the reasoning of Rev. Rul. 85-13, 1985-1 CB 184, and its progeny.

[48] Care should be taken to avoid the investment company rules under Code Sec. 721(b). Also, discounts in the estate tax area became more uncertain in light of Code Sec. 2704. To avoid Code Sec. 2704(b), which essentially provides that the inability to liquidate an interest will not be respected at death if that liquidation restriction occurs in a family-control setting, a term partnership is advocated. Code Sec. 2704(b) can be avoided if the liquidation restriction does not come from an "applicable restriction." An inability to liquidate resulting from state law is not an applicable restriction. The argument has been made that a term partnership results in an inability to liquidate by the limited partners under state law, and, therefore, it is not an applicable restriction. For example, under Section 603 of the Illinois Uniform Limited Partnership Act, a limited partner in a term partnership cannot withdraw and obtain his or her fair value prior to dissolution or the expiration of the term. The limited partnership interest would be argued to be subject to a substantial discount because of the inability of its holder to obtain the underlying value of the assets in the partnership. Other ancillary arguments are made to obtain discounts. Another argument supporting a discount from liquidation value is that a hypothetical willing buyer is faced with the uncertainty of whether the partners will admit that buyer in as a partner or whether the buyer will be restricted to being an assignee. Assignees may, under applicable state law, have no management rights, withdrawal rights, dissolution rights, or rights to review the books. Further, even assuming a limited partner may withdraw on six months' notice, in a non-term partnership, for example, withdrawal entitles a limited partner to "fair value" under the majority of state uniform limited partnership acts. This value arguably is not the same as liquidation value and may be based on a "going concern" valuation approach. The IRS has vigorously, and mostly unsuccessfully, attacked these partnerships using a variety of arguments in addition to the Code Sec. 2704 one. Among these are Code Sec. 2703, the step transaction doctrine, the three-year rule (or some transmogrification of it), equitable principles, and general valuation principles along the lines of the willing seller/willing buyer concept.

[49] A straightforward comparison illustrates this point: a gift of $10,000 cash versus a $10,000 IRA that must be immediately withdrawn. Both are viewed at $10,000 for gift tax purposes. But after taking out inherent income taxes at 40 percent, the $10,000 IRA is only worth $6,000 to the recipient donee on day one.

[50] Code Sec. 83(e) and Reg. §1.83-7.

[51] Reg. §1.83-7(b).

[52] *See, e.g., R.A. Cramer*, 101 TC 225, CCH Dec. 49,299 (1993), *aff'd* CA-9, 95-2 USTC ¶50,491, 64 F3d 1406. *See also* CCH IRS LETTER RULINGS REPORT NO. 1057, June 4, 1997, LTR 9722022 (Feb. 27, 1997).

[53] *But see* IRS Letter Ruling 9714012, *supra* note 46, which takes the opposite approach.

[54] *See*, IRS Letter Ruling 9722022, *supra* at note 52 (option not exercisable for at least 12 months from grant, expiration within 10 years, termination on voluntarily leaving employ). Code Sec. 83 does not apply because: (1) options subject to various restrictions on transferability; and (2) options cannot be exercised for at least one year; completed gift following the reasoning of Rev. Rul. 80-186 (but note that all options were vested in this circumstance); "after grantee A transfers the options, grantee A will have no power or right to determine when the options are exercised. In addition, the fact that the options may expire because grantee may resign or the corporation may terminate the grantee's employment would not render the gift incomplete". *See also* CCH IRS LETTER RULINGS REPORT NO. 1048, April 2, 1997, LTR 9713012 (Dec. 20, 1996) (option price equal to fair market value of stock on date of grant, length of option less than 15 years, transferable to family members; phase-in of full vesting over a seven-year period of time; that under Code Sec. 83(e)(3), Code Sec. 83 does not apply to the transfer of the option, and Reg. §1.83-7(a) does not apply because a gift transfer is not a "disposition" within the meaning of that regulation; exercise by transferee family members will result in income to the original holder/employee granted the option, with resulting step up in basis to the holder of the shares (equal to price at which option exercised plus income tax realized)).

[55] Reg. §1.83-7.

[56] Reg. §1.83-1(c).

[57] With a grantor trust, transactions between the grantor and the trust are not recognized for income tax purposes. Rev. Rul. 85-13, 1985-1 CB 184.

[58] The letter ruling is dated April 1998 and Rev. Proc. 98-34 is dated May 1998. On the issue of valuation, they are not consistent. The letter ruling, by implication, notes that the options do not have a readily ascertainable fair market value; the revenue procedure cuts the other way. Which is the IRS's real position?

[59] *See also* IRS Letter Ruling 9713012, *supra* note 54; IRS Letter Ruling 9714012, *supra* note 46; CCH IRS LETTER RULINGS REPORT NO. 999, April 24, 1996, LTR 9616035 (Jan. 23, 1996); CCH IRS LETTER RULINGS REPORT NO. 900, JUNE 2, 1994, LTR 9412013 (Feb. 23, 1994); and CCH IRS LETTER RULINGS REPORT NO. 876, Dec. 15, 1993, LTR 9349004 (June 8, 1993). For example, IRS Letter Ruling 9349004 indicates that upon exercising the option, the employee, not the person receiving the value of the option, recognizes ordinary income in an amount equal to the excess of the fair market value of the stock purchased over the exercise price of the option. However, the family member who exercises the option receives a basis equal to the exercise price paid plus the amount of income recognized by the executive. *Cf.* Reg. §1.83-4(b)(1). IRS Letter Ruling 9722022, *supra* note 52, provides a detailed analysis of the above issues.

[60] *See, e.g.*, IRS Letter Ruling 9722022, *supra* note 52; IRS Letter Ruling 9616035, *supra* note 59; CCH IRS Letter Rulings Report No. 945, April 12, 1995, LTR 9514017 (Jan. 9, 1995); and CCH IRS Letter Rulings Report No. 877, Dec. 22, 1993, LTR 9350016 (Sept. 16, 1993).

[61] IRB 1998-18, 7.

[62] 1984-2 CB 194.

[63] *See also* IRS Letter Ruling 9616035, *supra* at note 59 (acceleration of options under Plan because of termination of employment is an act of "independent significance" and does not affect gift tax consequences); IRS Letter Ruling 9722022, *supra* note 52 (options expiring on termination of employment an act of "independent significance" and no retained power for estate tax purposes).

[64] 1980-2 CB 280.

[65] Interestingly, analogizing to the partnership area, there is a question as to whether the option would qualify for the $10,000 annual exclusion under Code Sec. 2503(b). For example, is the option immediately exercisable if not vested? If not, does the recipient of the option have the immediate right to the enjoyment of the option? It seems that the answer is yes, although this area is uncertain. *But see* Morgan and Luepker, *supra* at note 12. Consider whether the donor could couple a gift of a non-vested option with a guaranteed payment right, to be fulfilled by the donor until the option becomes vested.