

April 17, 1998

## MEMORANDUM

### Re: Transferable Stock Options

The Internal Revenue Service has just issued a revenue ruling and a revenue procedure that address several issues regarding the gift, estate, and generation-skipping tax treatment of a transfer of a compensatory stock option. Copies of the revenue ruling and revenue procedure are attached to this memorandum.

In recent years, a number of companies have amended their stock option plans to allow some or all optionees to make gifts of nonstatutory stock options to family members, family partnerships, family trusts, and charitable organizations. Because statutory stock options (incentive stock options and options issued under qualified employee stock purchase plans) must be nontransferable prior to the optionee's death, they may not be transferred by gift.

An optionee who transfers a nonstatutory option does so in order to remove the option from his or her gross estate for federal estate tax purposes. The optionee often seeks to reduce the federal gift tax consequences of the transfer by making the transfer at a time when the value of the option is relatively modest (typically, soon after the option is granted, when the underlying stock has not appreciated significantly over the option exercise price).

Compensatory stock options are often exercisable only if the optionee remains employed by the company for a specified period after the option is granted. In the past, the Service informally took the position that the gift did not become complete for gift tax purposes until the option became exercisable. In Revenue Ruling 98-21, the Service confirmed its position by ruling that the transfer of an option to a family member does not become a completed gift until the later of (1) the date of the transfer or (2) the time when the donee's right to exercise the option is no longer conditioned on the donor's performance of future services.

The Service ruled that when an option becomes exercisable in installments, each installment is treated as a separate option. Thus, if an optionee makes a gift of an option immediately after the date of grant, and the option vests annually in three installments as long as the optionee's employment does not terminate, the optionee will be considered to make a completed gift of each installment on the vesting date for that installment.

The ruling confirms that the Service will continue to oppose efforts to minimize gift tax liability by transferring an option immediately after the option is granted, before the option is exercisable, and at a time when the value of the option is less than it will be after the underlying stock has appreciated.

In Revenue Procedure 98-34, the Service approved a method of valuing stock options for

gift, estate, and generation-skipping transfer tax purposes. The revenue procedure applies only to compensatory stock options on common stock that is publicly traded on an established securities market. The revenue procedure applies both to statutory and to nonstatutory options. (The revenue procedure applies to statutory options because, although a statutory option may not be transferred *before* the optionee's death, it may be transferred *after* the optionee's death.) The revenue procedure does not apply unless the company that grants the option is subject to Statement of Financial Accounting Standards No. 123 ("FAS 123") in preparing its financial statements.

Under the revenue procedure, a taxpayer may determine the value of an option by using a generally recognized option pricing model (*e.g.*, the Black-Scholes model or an accepted version of the binomial model) that takes into account factors that are similar to those established by FAS 123. In valuing the option, a taxpayer must, in general, use the variables that are disclosed in the company's financial statements for the fiscal year that includes the applicable valuation date.

The revenue procedure departs from the historical method of valuing options for estate tax purposes. In the past, options were typically included in the optionee's gross estate at a value equal to the excess of the underlying stock's fair market value over the option exercise price (*i.e.*, the "spread") as of the estate valuation date.

The revenue procedure states that the Service will treat the value of a compensatory stock option as properly determined if the taxpayer satisfies the requirements imposed by the revenue procedure. However, the revenue procedure does not purport to prescribe the way of valuing a compensatory stock option. The methodology approved by the revenue procedures is, in effect, a "safe harbor." This "safe harbor" is not available if the taxpayer discounts the results obtained under the option pricing model to reflect lack of transferability or other restrictions that apply to the option. If a taxpayer uses the revenue procedure to value an option, the taxpayer should indicate on the applicable gift, estate, or generation-skipping transfer tax return: "FILED PURSUANT TO REV. PROC. 98-34."

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