

Nonqualified Employee Stock Options — Gift and Estate Tax Issues

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An employee stock option (ESO) is a contractual agreement granting corporate employees the right to buy a designated number of shares of company stock, at a specific price, for a specific period of time. Managed prudently, this form of compensation can help an employee establish financial security for his or her loved ones.

The beauty of an ESO is in the deferral of tax liability due on the growing “bargain element” of the security. The bargain element represents the excess market value of the company stock over the option’s designated “strike,” or purchase, price. Unfortunately, many stocks have been trading below their option price.

The resurgence of the equity markets, however, has breathed some life back into these “underwater” employee stock options, the way spring rains rejuvenate sleeping vegetation. Before the anticipated economic recovery fully blossoms, strategies should be explored to shift the future appreciation of an ESO out of an estate, when the client does not expect to need the income that the security produces.

Stock options generally come in two varieties: incentive (ISOs) and nonqualified (NQSOs). The statutory requirements of the potentially Alternative Minimum Tax-poisonous ISOs are much more restrictive but, if complied with, can produce bountiful income-tax benefits. NQSOs lack the favorable tax treatment, but their greater flexibility can still reap rich rewards with proper planning.

Most of the available lifetime-planning strategies relate to NQSOs, since ISO grants are transferable only at death. A recent IRS regulation, however, now permits a lifetime transfer of an ISO to a grantor trust, established solely for the benefit of the grantor beneficiary, while still retaining its special tax status.



NQSOs can be transferred via gift, if permitted by the corporate option plan agreement. The employee remains liable, however, for paying income taxes due upon the exercise of the NQSO, even though he or she cannot realize any of the profits of gifted security.

The tax liability is calculated on the bargain element of an NQSO at the date of exercise; is reportable to the employee as W-2 compensation; and is subject to income, Social Security and Medicare tax withholding obligations. Payment of these taxes by the employee further reduces his or her estate, enhancing the benefits from the wealth transfer.

An employee can transfer ownership of NQSOs before they are fully vested. The transfer is not considered a completed gift, however, until the earliest of the dates that the option is irrevocably transferred or all conditions of future performance have been satisfied. Until then, gift tax reporting requirements are deferred and the options remain an asset includable in the employee’s estate. For a volatile security, this can create a substantial amount of liquidity risk (higher gift tax) and planning uncertainty, which a conservative client may want to avoid by waiting until the rights have vested.

Another strategy is for the employee to exercise the vested portion of the option contract, fund the withholding taxes, and then transfer ownership of the shares. Although administratively less intimidating, this strategy also can produce a slightly smaller economic benefit from the gift. For gift tax purposes, a lower value can be computed for the options than for the actual value of the shares using the Black-Scholes or another option-pricing model. Additional valuation discounts may be available if the NQSOs are transferred to a family-limited partnership or a trust established for family members.

The tax basis on any shares of stock acquired from exercising an NQSO is equal to the stock price at the date of exercise. If the employee continues to own the shares at his or her death, the securities are includable in the decedent’s estate and the beneficiaries inherit the security with a stepped-up basis.

Unexercised NQSOs owned by a decedent do not receive a step-up in basis. The bargain element is reportable as “income in respect of a decedent” (IRD) at the time of exercise, taxable to either the estate or the transferee owner. Since the tax liability due upon the exercise of a NQSO would normally have been reported by the deceased employee, private letter rulings have allowed the estate to be liable for the income taxes subsequently due upon exercise. If appreciating NQSOs continue to be held for a period after the decedent’s death, the income-tax liability on the increased IRD should be apportioned between the estate and the transferee. ■

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