

Efficient Use of Nonqualified Stock Options as a Wealth Transfer Vehicle

This article explains a useful technique that allows an executive to make a substantial transfer of the future net worth of nonqualified stock options with little, if any, gift tax liability, and retain control of the options during the option term.

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Despite the negative stock market returns over the last few years, nonqualified stock options (“NQSOs”) remain a major component of executive compensation plans. These are challenging assets for the wealth planning advisors of executives. A new technique called the Family Stock Option Plan uses a patented¹ methodology to transfer vested NQSOs to a SOGRAT®² (Stock Option eligible Grantor Retained Annuity Trust) in order to move the NQSOs’ future appreciation (in excess of the applicable federal rate or “AFR”) outside the taxable estate of an executive, with minimal, if any, transfer tax cost.³

Employee stock options

A stock option is a right to purchase a certain number of shares of corporate stock at a specified price for a specified period. There are two types of options currently used in executive compensation programs: the incentive stock option

(“ISO”), which provides tax benefits under Section 422 of the Internal Revenue Code, and the nonqualified stock option, which is any option not qualifying under Section 422. This article focuses on planning with NQSOs, as ISOs are nontransferable.⁴

NQSOs are granted with a fixed exercise or “strike” price “at the money” (e.g., \$50 stock price on

grant date, \$50 exercise price). The options are subject to the compensation program’s vesting schedules and may be exercised for a certain period after they are vested. There are no tax consequences to the executive when the options are granted. However, when the executive exercises the options, he will recognize as ordinary income the difference between the strike price and the current stock price.

Generally, companies grant executives options every year, and these options typically have a ten-year term until expiration. Therefore, it is likely that many executives hold ten years of option grants at any given time. A useful planning technique for handling options is the Family Stock Option Plan (“FSOP”). Before explaining how the FSOP works, it may be helpful to analyze the valuation of NQSOs.

Valuation of NQSOs

The procedure used to value NQSOs has been debated for a

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number of years. Many advisors believe that the value of an option should be the difference between the current stock price and the exercise price. The difference between the strike price and the current stock price is known as the "intrinsic" value, or the "in the money" value. This value, though, does not include any premium for the remaining time the options are allowed to be held, also known as the "time value."

In Rev. Proc. 98-34,⁵ the Service set forth a method to value NQSOs for gift, estate, and generation-skipping transfer ("GST") tax purposes. Specifically, the Service stated that NQSOs should be measured using a generally recognized option-pricing model, such as the Black-Scholes model or an accepted version of the binomial model. No

discount may be applied to the value derived using these models.⁶

Example. Assume that a company grants an executive 100,000 NQSOs at a \$50 strike price and the stock appreciates at 10% per year. Also assume that the corporation's option plan allows the options to be transferred⁷ and that the options vest after two years.

No transfer. In this example, at the end of ten years, the stock price will be \$129.68. If the executive holds the NQSOs and then exercises the options at the end of ten years, he will recognize \$7,968,000 of income (\$129.68 current stock price minus \$50.00 strike price = \$79.68 taxable income per option times 100,000 options = \$7,968,000). This amount will be

subject to federal income tax of 35%⁸ and Medicare tax of 1.45%, for a total tax liability of \$2,904,336.

After taxes, the executive's net proceeds from this one option grant will be \$5,063,664.⁹ These proceeds will be included in the executive's estate and, assuming a federal estate tax rate of 50%, will trigger a federal estate tax liability of \$2,531,832.¹⁰ After estate taxes, the executive's heirs will receive \$2,531,832, which is less than 32% of the gross proceeds the executive received when the options were exercised.

Outright gift. In order for the executive to make a completed gift of the options, the options must be vested.¹¹ Therefore, assume the executive makes a gift of the options to his children exactly two years from the date the options were initially granted (the first date on which the options are vested). According to Rev. Proc. 98-34, using the Black-Scholes formula, the executive will have made a taxable gift of \$2,159,000 (100,000 options × \$21.59) (see Exhibit 1). The executive's federal gift tax liability for the NQSOs will range

¹ Patent #6,567,790 was granted to Wealth Transfer Group, LLC on 5/20/03. No rights under the patent are to be inferred by the publication of this article.

² SOGRAT® is a registered service mark of the Wealth Transfer Group, LLC.

³ Walton, 115 TC 589 (2000), *acq.*, Notice 2003-72, 2003-44 IRB 964.

⁴ Section 422(b)(5).

⁵ 1998-1 CB 983.

⁶ Rev. Proc. 98-34.

⁷ Effective 8/15/96, transfer of NQSOs is allowed

under SEC Release No. 34-37260.

⁸ Maximum federal income tax rate under the Jobs and Growth Tax Relief Reconciliation Act of 2003.

⁹ The net proceeds will be lower if the taxpayer's state of residence imposes an income tax.

¹⁰ This computation assumes constant dollars and no permanent repeal of the estate tax. The tax will be higher if the taxpayer's state levies an inheritance tax or a state death tax.

¹¹ Rev. Rul. 98-21, 1998-1 CB 975.

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EXHIBIT 1 Value of Options

End of Year	Stock Price	Black-Scholes Value per Option
1	\$ 55.00	\$18.61
2	60.50	21.59
4	73.21	29.23
6	88.58	40.10
8	107.18	56.14
10	129.68	79.68

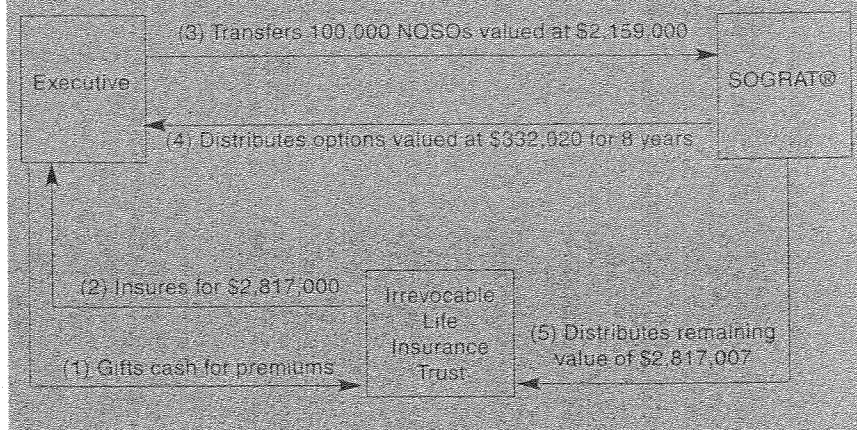
The Black-Scholes values assume a volatility of 30%, expected dividend yield of 2.5%, and a risk-free interest rate of 4%.

from \$579,500 (if no prior lifetime gift tax exemption has been used) to \$1,079,500 (if all prior lifetime exemption has been used).¹²

Furthermore, when the children exercise the options, the executive must report all income resulting from the children's exercise,¹³ and must pay taxes on the difference between the strike price and the current stock price. If the children hold the options until expiration and then exercise at a stock price of \$129.68 (see Exhibit 1), the executive's total income tax liability will be \$2,904,336. If the children wait until expiration to exercise the options, the total income and gift taxes paid by the executive will be between \$3,483,836 and \$3,983,836. However, the children will net the entire \$7,968,000 of gross value derived from the exercise of the options.

As shown in the above example, if the executive gifts the NQSOs outright, there are several disadvantages. First, the executive will have significant gift and income tax liability, and would have to possess considerable other liquid assets to pay those taxes. Second, if the stock decreases in value after the executive makes the gift, the children could receive less upon exercise than the

EXHIBIT 2 Components of the FSOP



amount the executive reported as a taxable gift, and the children could possibly receive nothing if the stock price falls below the strike price. Third, if the executive dies before the expiration of the options, the children could be forced to exercise the options within three to 12 months of the executive's date of death. The reason is that many option plans require an accelerated exercise at the executive's death,¹⁴ regardless of who owns the options on the executive's date of death. A forced accelerated exercise could cause the family to lose substantial future appreciation in the options after the executive's death.

The Family Stock Option Plan

The FSOP allows an executive to (1) transfer a portion of the future appreciation of vested NQSOs from his taxable estate with little transfer tax cost, and (2) remain in total control of the options (as trustee) during the option exercise period. The process is relatively simple and involves (1) a SOGRAT®, (2) an irrevocable life insurance trust ("ILIT"), (3) a valuation of the NQSOs, both initially and annually, (4) a cash contribution, and (5) a determination of the optimal annuity payment schedule.

The SOGRAT®. The first component of the FSOP is a SOGRAT®. The executive will transfer all, or a percentage, of the executive's vested NQSOs into a SOGRAT®. The length of the SOGRAT® annuity term will typically be the time remaining until the options expire. Cash in an amount necessary to fund any ongoing fees, such as valuation fees, should also be contributed to the SOGRAT®.

During the annuity term, the executive may be either a trustee or co-trustee of the SOGRAT®. As trustee, the executive will make all decisions regarding the exercise of the NQSOs and thereby will retain control over the stock options.

When the SOGRAT® is created, the planner will use computer modeling to determine the annuity payments, any special terms, and the reported taxable gift. In accordance with the Tax Court's decision in *Walton*,¹⁴ the SOGRAT® should be designed so that the reportable taxable gift is

¹² This assumes a 50% gift tax rate.

¹³ Section 83; see also Rev. Rul. 2004-37, 2004-11 IRB 583.

¹⁴ 115 TC 589 (2000), *acq.*, Notice 2003-72, 2003-44 IRB 964.

¹⁵ It is prudent to create a gift of at least \$1 to preclude the Service's possible argument that the transaction is a sham.

EXHIBIT 3 Annuity Payments of Trust

Year	Executive Owned Options	SOGRAT® Owned Options	SOGRAT® Options Paid To Executive	End of Year Total Executive Options	End of Year SOGRAT® Options
1	0	100,000	-13,233	13,233	86,767
2	13,233	86,767	-11,359	24,592	75,408
4	34,309	65,691	-8,280	42,589	57,411
6	49,607	50,393	-5,914	55,521	44,479
8	60,479	39,521	-4,167	64,646	35,354

an amount approaching zero.¹⁵ Because of low AFRs, an executive can transfer a portion of the future value of the NQSOs to the remainder beneficiary without requiring a high rate of growth on the underlying stock. In fact, assuming moderate volatility of the underlying stock, options will increase in value at a rate greater than the appreciation rate of the underlying stock. This phenomenon is illustrated in

Exhibit 1 where the Black-Scholes value per option grows at an increasing rate of over 16% while the underlying stock price grows at a constant rate of 10%. The ability to leverage the rate of return on assets held inside the SOGRAT® makes the technique even more advantageous.

The required annuity payments can be made as payments in kind, by distributing NQSOs held inside the SOGRAT® to the executive (grantor). This is not an income-taxable event because the SOGRAT® is a grantor trust.¹⁶ The options comprising the in-kind annuity payment should be valued each year, using the method prescribed in Rev. Proc. 98-34. How-

ever, if a party other than the SOGRAT® pays for the annual valuation, it could be interpreted as an impermissible additional transfer to the SOGRAT®.¹⁷ Accordingly, the cash contributed to the SOGRAT® will be used to pay for the annual valuation of the NQSOs payable to the executive in order to alleviate the possibility of disqualification of the SOGRAT® as a GRAT. Because the annuity payment is made in kind, the annuity is satisfied in part by the same time-value premium that was applied to the options when they were contributed to the SOGRAT®, reducing the disadvantage of including the time-value premium at contribution.

Irrevocable life insurance trust.

The second component of the FSOP is an irrevocable life insurance trust, which is set up as the remainder beneficiary of the SOGRAT®. To avoid an inefficient use of the executive's GST exemption, the ILIT will be a non-generation-skipping trust.¹⁸ The assets remaining in the SOGRAT® at the end of the trust term will be distributed to the ILIT and may be used for insurance pre-

¹⁵ Rev. Rul. 85-13, 1985-1 CB 184.

¹⁷ Reg. 25.2702-3(b)(5).

¹⁸ Under Section 2642(f) (commonly referred to as the ETIP rule), the executive will not be able to allocate GST exemption to the NQSOs transferred to the SOGRAT® until the end of the annuity term. The advisor should make sure that premiums paid during the annuity term are excluded from the automatic allocation of GST exemption.



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EXHIBIT 4 Three Scenarios

	Executive Keeps All	Outright Gift *	FSOP
Options Vested in Year 2			
Executive's Gross Estate at Vesting **	\$6,159,000	\$6,159,000	\$6,159,000
Reported Gift	N/A	\$2,159,000	\$1***
Gift Tax Paid	N/A	-\$1,079,500	-\$1
Executive's Net Estate After Gift and Gift Tax Liability	\$5,159,000	\$2,920,500	\$6,158,999
Options Exercised at Expiration in Year 10			
Value Transferred by Exercise	N/A	\$7,968,000	\$2,817,007
Executive's Gross Estate at Exercise ****	\$11,968,000	\$2,920,500	\$9,150,992
Executive's Income Tax Liability at Exercise	-\$2,904,336	-\$2,904,336	-\$2,904,336
Executive's Net Estate at Exercise	\$9,063,664	\$16,164	\$6,246,656
Amount to Heirs if Executive Dies in Year 10 After Options Exercised			
Estate Tax on Executive's Remaining Estate	-\$4,531,832	-\$8,082	-\$3,123,328
Heirs' Net Inheritance	\$4,531,832	\$8,082	\$3,123,328
Total Transferred to Heirs During Executive's Life and at Death	\$4,531,832	\$7,976,082	\$5,940,335
Total Cash Expended to Implement Strategy	\$0	\$3,983,836	\$1

* Client must have \$3,983,836 in other cash assets to pay gift and income taxes.

** Executive's estate at the end of year 2 includes the value of the NQSOs and \$4 million in other cash assets. The other cash assets are used to pay for any gift and income taxes that cannot be paid for by the exercise of the NQSOs. Under the "Outright Gift" alternative, the executive must have \$1,079,500 (50% gift tax) when the options are vested to pay the gift tax incurred, and he must have \$2,904,336 when the options are exercised to pay the income tax incurred.

*** Assumes the *Walton* decision applies.

**** Cash assets are assumed to grow at a net rate of 0%. Gift and income taxes are assumed to be paid at year-end.

miums and other potential applications.

The Service takes the position that if the grantor dies during the term of a GRAT, the assets in the GRAT are included in the grantor's estate.¹⁹ To offset this risk, the ILIT will buy insurance on the grantor's life. Computer modeling with a stated stock appreciation rate or specific stock price points will calculate an expected remainder value at the expiration of the SOGRAT® term. The trustee of the ILIT should purchase insurance in the amount of the expected remainder value.

In addition to paying estate taxes that may be due if the executive dies during the trust term, the insurance serves a second purpose. The insur-

ance replaces the lost future value of the options due to a mandatory early exercise caused by the executive's death, thus guaranteeing the success of the FSOP.

Termination of the SOGRAT® term and funding of the ILIT. At the end of the SOGRAT® term and after the last annuity payment has been made, the trustee of the SOGRAT® will distribute the remaining NQSOs to the ILIT. The trustee of the ILIT (who should not be the executive) can then exercise the NQSOs and sell the stock, keeping the full cash proceeds inside the ILIT. The executive will be liable for the income tax resulting from the trustee's exercise of the options, as long as the options

were transferred for no consideration.²⁰

It is important to remember that a zeroed-out GRAT²¹ transfers only future appreciation in excess of the Section 7520 rate, and no amount of current value. Hence, the executive has not given away any current net worth when implementing this technique.

The components of the FSOP are illustrated in Exhibit 2. Using the facts of the earlier example, the NQSOs are not transferred to the SOGRAT® until the options are

¹⁹ Section 2036.

²⁰ Section 83 and Notice 2003-47, 2003-30 IRB 132.

²¹ A zeroed-out GRAT is defined as a GRAT that causes a taxable gift of less than \$100 but more than \$0.

vested. At the end of the eight-year GRAT term, the ILIT receives \$2,817,007 of value consisting of the remaining options in the SOGRAT. The executive receives \$5,150,993²² worth of NQSOs that were paid to him in kind to satisfy the required annuity payments (see Exhibit 3).

In summary, using the single SOGRAT® example, \$2,817,007 of value is transferred to the ILIT in just eight years, with a reported gift of \$1. The \$2,817,007 of cash, derived from the exercise of the options, can be used to pay future premiums on the insurance policy owned by the trust, unwind premium financing arrangements and enter into arm's-length transactions, including installment sales and asset purchases, with the executive.

Under Section 83, the executive must report as ordinary income the entire gain on the exercise of the options, regardless of who owned the options at the time they were exercised. After paying income taxes due of \$2,904,336, the executive will net \$2,246,657. Under *Walton*, the reported gift would be approximately \$1. This compares to the reported gift of \$2,159,000 under the outright gift example discussed previously.

Exhibit 4 compares three scenarios: (1) the executive keeps all the NQSOs (no gifting program), (2) the executive gives the NQSOs outright to his children, and (3) the executive transfers the NQSOs using the FSOP technique. The FSOP shifts over \$2.8 million outside the taxable estate in eight years with virtually no gift tax. The "Outright Gift" (shown in Exhib-

it 4), while transferring the most value, has the highest personal unrecoverable cash cost²³ to the executive of almost \$4 million.

Series SOGRATs®. To maximize the number of stock options passing to the remainder beneficiary, the executive can re-GRAT the NQSOs he receives each year from the SOGRAT®'s in-kind annuity payment. In our scenario, when the executive receives 13,233 options from the original SOGRAT® after the first year, he can create a new seven-year SOGRAT® with the options received. When the executive receives the annuity payments in the second year from the first SOGRAT® and the second SOGRAT®, he can create a new six-year SOGRAT®. This process can continue until the executive has seven different SOGRAT®s. All SOGRAT®s would expire on the same date.

As an illustration, assume the stock appreciation, risk-free interest rate, dividend yield, and 7520 rate in our previous example remain constant. By using the series SOGRAT®s, at the end of eight years, the executive would receive 42,628 options with a value of \$3,396,599 and the ILIT would receive 57,372 options with a value of \$4,571,401. The executive, after paying income taxes of \$2,904,336, would net \$492,263, and the trust would net the entire \$4,571,401 of proceeds. The reported taxable gift for each SOGRAT® will be approximately \$1, and the total gift reported will be \$7.


Conclusion

The patented FSOP method creates a useful estate planning opportunity for planners with clients holding NQSOs. The FSOP technique allows an executive to make a substantial transfer of the future net worth of NQSOs with little, if any,

gift tax liability, and retain control of the options during the option term. The FSOP technique also allows the executive to use the proceeds from the exercise of options to pay the income tax liability associated with the exercise so that the executive does not deplete his other personal funds.

The transfer of the NQSOs to a trust outside the executive's estate provides, in a transfer-tax-efficient manner, the seed capital required for numerous future leveraged planning opportunities, including self-canceling installment notes ("SCINs"), private annuities, and installment sales. The proceeds could also be used to repay premium financing arrangements or split-dollar arrangements without gift taxes. As estate planning professionals combine the FSOP with other techniques, the client's estate and wealth transfer planning can be greatly enhanced. ■

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²² This assumes a constant 4.8% Section 7520 rate and assumes the stock appreciation, risk-free interest rate, and dividend yield in our previous example remain constant.

²³ Unrecoverable cash cost is cash cost for gift and income taxes that is not derived from option exercises.