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Stock Options and Charitable Giving: Do They Mix?

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As those of us who are not in the high-tech world know all too well, the “real money” these days is in stock options. Perhaps I have a skewed sense of reality since I live so close to ground zero (Silicon Valley), but it seems that donor prospects are popping up everywhere, and what they have to give are stock options or shares of stock received from exercising options. This article will review the common types of stock option plans and then attempt to answer the question: How do you make a charitable gift if what you have are options?

What are Stock Options?

A stock option is a contractual right given by a corporation to an employee (or independent contractor) to purchase the corporation’s stock. This right extends for a stated period of time and gives the holder the right to buy the stock at a fixed price. This price is usually the fair market value of the stock at the time the option is granted. The employee’s ability to exercise (purchase stock at the option price) is deferred to some time in the future, and may be conditioned upon continued employment. The employee hopes, of course, that the stock price will increase over time, so that the stock will be worth substantially more than the option price when the option becomes exercisable.

Generally, there are two types of stock options: Incentive stock options (ISO), also referred to as statutory options because they meet the requirements for favorable federal income tax treatment; and nonstatutory stock options (NSO), also called non-qualified options. NSOs are generally more flexible than ISOs, but do not have as favorable of a tax treatment. Because the amount of ISOs that can be issued to an employee is limited, the majority of existing stock options are NSOs, at least among executive-level employees.

Before beginning any inquiry into whether someone should donate a stock option, you must first review the terms of the stock option plan or agreement to determine whether a transfer of the option itself is even possible. Many plans place stringent restrictions on the transferability of options. For example, a company may restrict the transfer of options in an effort to maintain control of the company with individuals who have a vested interest in its success, such as employees. Moreover, if the stock option is an incentive stock option, the tax law severely restricts the ability to transfer the options. The option holder may have a copy of the plan, although the company or the plan administrator is often a better source. In addition, the company’s SEC filings generally include a copy of the plan, plus details of the executive’s holdings.

In order to understand the consequences of giving an option (or the stock received from exercising an option), first we must discuss the tax consequences associated with receiving, holding and exercising options. Income tax can potentially be assessed on a stock option at three points in time: 1) upon the granting of the option; 2) upon the transfer of the option by the employee (if allowed); and/or 3) upon the exercise of the option (leaving aside, for the moment, any income tax that could be assessed upon the ultimate sale of the stock received from exercising the option). As discussed below, the rules are quite different for ISOs and NSOs.

Incentive Stock Options

Taxation

ISOs are defined in the Internal Revenue Code (IRC) § 422(b) and governed by IRC §§ 421 through 424. The exercise price under the option plan or agreement must be at least equal to the stock's fair market value on the date of the grant. No more than $100,000 in ISOs (held by the employee) may become exercisable for the first time in any one year.[1] Generally, ISOs cannot be granted to an individual who owns more than 10% of the company's voting power.[2]

Neither the granting nor the exercise of an ISO will give rise to income tax if the employee holds the shares for a minimum holding period and does not exercise more than three months after leaving employment. ISOs are thus very attractive, as the employee does not recognize income until he or she finally sells the shares of stock received from the exercise.

To obtain the favorable treatment, the shares received upon exercise must be held by the employee for at least: 1) two years from the date the option was granted; and 2) one year from the date the option was exercised.[3] Also, the employee must remain an employee of the granting company (or a parent or subsidiary of, or successor entity to, the company) throughout the period from the date of the granting of the option through the day three months prior to its exercise.[4] Thus, if the employee waits at least two years from receiving the option and one year after exercising it, he or she will not be taxed on either the grant of the option or on its exercise (subject to the alternative minimum tax). At that point, the ISO stock is a long-term capital asset to the employee.[5] Accordingly, the employee will be taxed only when he/she eventually sells the ISO shares, and then only at capital gains rates. The gain is calculated as sales price minus basis (option price paid at exercise).

While the exercise of an ISO enjoys favorable treatment for regular tax purposes, the difference between the fair market value of the stock on the date of exercise and the option price is included in the employee's alternative minimum tax (AMT) calculation.6 As a result, employees who exercise ISOs often find themselves paying AMT. The tax basis in ISO shares for regular tax purposes will be the amount paid for the shares, but for AMT purposes it will be the fair market value at the date of exercise. Any AMT paid by the employee at exercise is allowed as a credit against the employee's regular tax (including any capital gains tax on the sale of the stock) in future years.

If the employee disposes of the ISO stock prior to satisfying the holding period, the ISO will lose its favorable tax status. The employee will, in the year of exercise, recognize compensation income equal to the difference between the fair market value of the stock at the time of exercise and the option price. Compensation income is, of course, taxed as ordinary income and subject to withholding and the various employment taxes. In addition, any appreciation in the shares from the date of exercise to the date of disposition will be a capital gain. For this purpose, the term "disposition" includes almost any transfer of legal title, including a gift.[7]

Gift of ISOs and ISO Shares

ISOs can only be transferred at the death of the employee.[8] As a result, an employee cannot transfer an ISO to charity (or anyone else, for that matter) during his or her lifetime. Thus, inter vivos gift opportunities tend to focus on ISO shares.

At the risk of being redundant, it is crucial to keep in mind that a gift of ISO shares to charity prior to the expiration of the required holding period will completely undo the employee's favorable tax treatment and cause him or her to recognize compensation income. Accordingly, it is not advisable to recommend a gift (either outright or life income vehicle) of shares acquired through the exercise of an ISO unless you are sure that the shares have been held for the requisite time period.

Once the employee has held the ISO shares for the requisite time period, a gift of those shares will be deductible in the same fashion as other long-term capital assets. The employee will receive a full fair market value charitable deduction as of the date of transfer, which can be used to offset up to 30% of the employee's adjusted gross income.[9] Because no capital gain is recognized on a gift, a charitable donation of ISO shares can be an attractive alternative to a sale. Alternatively, the ISO shares can be used to fund a CRT once the holding period has been satisfied.

Recognize, however, that there is an additional "cost" in giving ISO shares due to the AMT paid at the time of exercise. If the shares are given to charity, the employee loses the benefit of having a higher AMT basis in the shares, and the potential benefit from the reversal of the AMT preference may be lost. A detailed discussion of this issue is well beyond the scope of this article, and the actual impact to a particular individual can be determined only upon a review of his or her entire tax situation. Nonetheless, owners of ISO shares often find that a gift of ISO shares may not be as attractive as a gift of other appreciated assets.

As is true with the gift of any securities, it is important to determine if there are any contractual or securities law restrictions imposed on the transfer of the shares. At a minimum, such restrictions could cause the shares to have a value below that of unrestricted shares due to the lack of marketability, and trigger the requirement for an appraisal under IRC § 170(f)(8).

Bequest of ISOs and ISO Shares

The favorable tax treatment applicable to the exercise of an ISO is not lost upon the death of the employee. The ISO plan may allow the ISO to be exercised by the employee's estate or the beneficiary who acquires the ISO by bequest. The employee's estate or the beneficiary will enjoy the same tax treatment on exercise as would the employee.[10] Further, there is no requirement that the estate or beneficiary exercise the option within three months of the employee's death.[11] Thus, bequeathing an ISO to charity will generate a charitable deduction for the estate, and with proper planning, favorable income tax treatment for the recipient charity.

If an employee exercises an ISO and thereafter dies, the transfer of the ISO stock to the estate or beneficiary is not a disposition of the ISO stock and does not trigger tax.[12] The recipient "steps into the shoes" of the decedent/employee and acquires the favorable ISO tax treatment. Again, a gift of ISO shares to charity can generate an estate tax deduction and favorable income tax treatment for the recipient charity.

Nonstatutory Stock Options

Taxation

NSOs are considered to be compensation received by the employee in exchange for the provision of services, and are thus includable in the employee's gross income.[13] NSOs are generally subject to taxation as income upon either: 1) the initial grant to the employee if the option has a readily ascertainable value (i.e., is publicly traded on an established securities exchange); or 2) when the NSO is exercised or "otherwise disposed of."[14]

Most often, the option does not have a readily ascertainable value at the date of grant, and the employee will be subject to tax only at the time of exercise. The income attributed to the exercise of the NSO will be the difference between the fair-market value of the stock at the time of exercise and the exercise price, which is generally the fair market value at the date of the grant. This amount is taxed as ordinary income. At that point, the employee has shares of stock with a basis equal to the stock's fair market value on the date of exercise and a holding period that begins at the date of exercise. Alternatively, if the employee transfers or disposes of the NSO in an arm's-length transaction, he or she recognizes income in an amount equal to the difference between the amount received and the exercise price.[15]

Note that an individual with NSOs can elect to be taxed upon the grant of the NSO, but this is rarely done because it is so difficult to determine the value of the NSO.[16]

Gift of Stock

If the employee makes a charitable donation of the stock received from exercising an NSO within 12 months of the exercise date, he or she will be allowed a charitable deduction for income tax purposes that can be used to offset the income recognized at exercise. However, the deduction will be equal to the employee's basis in the stock (i.e., exercise price plus the amount taken into income at exercise) because the stock is not a capital asset held long term. As partial compensation for the basis-only deduction, the employee can use the deduction to offset up to 50% of his or her adjusted gross income (as opposed to 30%), because the shares are not yet "capital gain property" for purposes of IRC §§ 170(b)(1)(A) and (B). At best, an exercise followed by a gift of the shares within 12 months will result in a "wash" to the employee for income tax purposes.

If the employee makes a charitable donation of the stock after satisfying the 12-month-holding period, his or her deduction will generally be equal to the stock's fair market value at the date of the gift, subject to the 30% of adjusted gross income limitation.

Gift of NSO

Unlike ISOs, an employee can transfer NSOs during life if the individual stock option plan or agreement permits. Some plans allow transfers to family members or trusts for family members. Some enlightened companies are amending plans to allow transfers of NSOs to charities as well. Therefore, charities might consider approaching donors about a gift of NSOs. Even if the plan does not currently allow a gift of NSOs to charity, a donor with sufficient influence at the company may be able to convince the company to amend its plan. However, it is not clear what advantage, if any, can be obtained by such a transfer as opposed to simply exercising the option and transferring the stock or cash instead.

The problem stems from the fact that NSOs are deemed to generate compensation income to the employee (even if given to charity), and a potential timing difference between the recognition of income and the completion of the gift for charitable contribution deduction purposes.

The gift of the NSO to charity does not trigger any income to the employee.[17] However, if an employee donates an NSO to charity (or to a CRT for that matter), he or she—not the donee charity—will be taxed on the income realized by its subsequent exercise because the option is considered compensation to the employee for his or her services. [18] In other words, when the charity eventually exercises the option, the employee will recognize income on the difference between the fair market value at the date of exercise and the option price.

To further complicate matters, the event triggering the income to the employee (i.e., the exercise of the option) is not necessarily the same as the event triggering the charitable deduction. The IRS recently issued Revenue Ruling 98-21[19] addressing the gift (not income) tax consequences of a gift of an NSO in a noncharitable context. The ruling holds, for gift tax purposes, that the gift of an NSO is complete at the later of: 1) the transfer date; or 2) the time when the donee's right to exercise the option is vested and absolute. While this ruling focused upon the gift tax consequences of a transfer to a family member, the theory should also apply to the income tax consequences of a transfer to charity. However, this timing rule can pose a problem in the charitable giving context. Consider the following example: An employee has an NSO that will not vest (meaning the employee cannot exercise the NSO) until he works at the company for a specified period of time. He gives the NSO to charity on January 15th and then completes the service requirement on July 31st, at which time the option is vested and exercisable. However, the charity waits until December 15th to actually exercise the option.

When has the employee completed this gift to charity? Revenue Ruling 98-21 tells us that the gift is complete on July 31st. What is the amount of the employee's charitable deduction for income tax purposes? The donor has made a gift of an item of property, the sale of which would trigger ordinary income.[20] Accordingly, the deduction must be reduced under the rules of IRC § 170(e) from the fair market value of the NSO on July 31st to basis, which is zero. The gift is, in other words, an assignment of income. The employee thus runs the risk of having compensation income with no offsetting deduction.

There is a solution to this timing difference, however. Although they are not precedent, three companion private letter rulings discuss the consequences of an employee donating an NSO, but retaining the right to designate when the charity may exercise. [21] The rulings hold that the gift to the charity is complete and the deduction allowed only when the condition is satisfied and the charity, with the approval of the donor, actually exercises the NSO. In other words, the donor's income and deduction occur at the same moment—the date of exercise. The rulings hold that the deduction is not reduced under IRC § 170(e), and is deductible up to 50% of the employee's adjusted gross income (AGI). Why? Because Treas. Reg. § 1.170A-4(a) provides that the reduction rules of IRC § 170(e) do not apply where, by reason of the transfer of the contributed property, the donor recognizes income in the same year as the contribution. Further, the rulings hold that the NSO is not a "capital gain asset" triggering the lower 30% of AGI limitation, because its sale would have generated compensation income, not long-term capital gains. In other words, if the gift of property triggers income to the donor, the donor is essentially treated as if he/she gave cash, not appreciated property. While it was technically not the transfer of the NSO that triggered the income (it was the subsequent exercise), the rulings found that the effect was sufficiently similar. This result seems correct because it is the same event that triggers the income and constitutes the completed gift. Without such a condition, however, the gift and income events are not at the same time, and the IRS may not extend the rule of Treas. Reg. § 1.170A-4(a) to permit a deduction.

Note that the donation of the NSO to charity is also a transfer for gift tax purposes; however, the gift becomes complete and fully deducible at the time the NSO becomes exercisable (or actually exercised if the donor retains the power of approval).[22]

Even with the retention of a condition, the employee basically recognizes income and an offsetting deduction at the time of exercise; the result is at best a "wash." The employee can eliminate this uncertainty and complexity by retaining the NSO, exercising it him/herself, and then donating the stock. The employee will then know exactly what the amount of his or her income will be, and the offsetting value of any charitable deduction. Better yet, the employee could exercise the option and give other appreciated assets.

Bequest of NSO

While an inter vivos gift of NSOs does not appear particularly advantageous, a testamentary transfer of NSOs to charity may provide some real benefits to the donor. Like retirement plan assets, stock options do not receive a stepped-up basis at death. Any gain recognized upon the subsequent exercise of the NSOs will be deemed "income in respect of a decedent" (IRD) and included in the gross income of the person or entity that receives and exercises the option.[23] A very recent private letter ruling reviewed the consequences of bequeathing NSOs to charity.[24] The founder of a company had been granted NSOs under a plan that allowed him to transfer the options at death to a class of beneficiaries that included charitable organizations. The IRS ruled that if the founder, in fact, willed his options to a charity, and the charity, after the founder's death, exercised the options, any income realized by the charity would be IRD to the charity, not to the founder's estate. Courtesy of the charity's tax-exempt status, the IRD would escape taxation. Additionally, the IRS ruled that the donor's estate would be entitled to an estate tax charitable deduction for the value of the NSOs.

This is an important ruling. Like retirement plans, leaving NSOs to family members or friends at death can be a very expensive gift: The NSOs will trigger both estate tax to the decedent and income tax to the recipient. As we have all hopefully come to learn over the past few years, the combined tax rate on such a gift can approach 70% to 80%. Giving the NSOs to charity, however, will completely avoid both estate and income tax, resulting in a gift of every penny to charity.

Corporate Gift of NSO

Some creative charities have started to approach the start-up company itself, as opposed to the employee, for gifts of NSOs. In fact, at least one charity, Entrepreneurs' Foundation of Menlo Park, California, focuses its fundraising efforts on securing gifts of stock and stock options from start-up companies.[25]

A company that gives NSOs to charity does not recognize any income, either at the time of the gift or when the charity exercises the NSO and pays for the shares.[26] Thus, unlike an individual donor, a company donor can generate an income tax deduction without any corresponding recognition of income. However, the charitable deduction will not be allowed until the time that the charity actually exercises the option, because the option is considered a mere promise to pay, not a "payment."[27] Revenue Ruling 75-348 holds that a corporation that granted a vested and exercisable option to buy its stock to a charitable organization is only entitled to a deduction in the year the option is actually exercised. The ruling also holds that because the company realizes no gain on the sale of its stock, neither the bargain sale rules of IRC § 1011(b) nor the reduction rules of IRC § 170(e) apply. Accordingly, at the time of exercise, the amount of the contribution will be the excess of the fair market value at the time of exercise over the option price.

Special Considerations for Private Foundations

Private foundations are subject to a series of restrictions and excise taxes, courtesy of the Tax Reform Act of 1969, which do not apply to public charities. As a consequence, there are special considerations that apply when NSOs are given to a foundation.

Net Investment Income

A private foundation must pay an annual excise tax equal to between 1% to 2% of its net investment income.[28] Net investment income is computed by adding the foundation's gross investment income and capital gain net income, and subtracting the ordinary and necessary expenses incurred for the collection of that income or for the management of income-producing property.[29] In determining capital gain net income, only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents and royalties, and property used for the production of unrelated business income are taken into account.[30]

Property is treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type that generally produces interest, dividends, rents or royalties.[31] The regulations provide some examples, including rental real estate, stock, bonds, mineral interests, mortgages and securities. Although not precedent, the IRS has ruled in several private letter rulings that stock options are not assets that generally produce such income, and therefore any gain on exercise is not subject to the excise tax.[32] However, the subsequent sale of the stock obtained through the exercise of an option would be a disposition subject to the excise tax.

Self-Dealing Issues

A foundation must pay particular attention to the gift of stock options from a disqualified person. The sale, exchange or lease of property between a foundation and a disqualified person constitutes a prohibited transaction.[33] Thus, if the donor is a disqualified person, the stock option must be donated to the foundation; it cannot be sold, even at a discount.

Likewise, caution is required if a company gives a foundation options to purchase its stock. This situation arises most frequently when the foundation is a so-called "company foundation," established and funded primarily by one company to conduct charitable activities on behalf of the company. At exercise, the foundation will be required to pay the option price to the company in exchange for the stock. If the company is a substantial contributor, or otherwise a disqualified person to the foundation, the sale would be a prohibited transaction.[34]

One solution to this problem is to have the foundation sell the options to an unrelated charitable organization. Presumably, the unrelated charity would pay the foundation an amount close to the difference between the fair market value of the stock and the option price. This sale would not be an act of self dealing because the payment to the foundation is made by the unrelated charitable organization that, by definition, is not a disqualified person.[35] Likewise, the eventual payment to the company to exercise the options and convert them to stock would be paid by the unrelated charity, not the foundation. Several private letter rulings have ruled that this approach does not constitute self dealing.[36]

Mandatory Distributions

A foundation must make qualifying distributions in an amount equal to 5% of the fair market value of its noncharitable assets each year.[37] If a foundation has stock options that are fully vested and exercisable, they would appear to have to be included in the foundation's calculation of its noncharitable assets. On the other hand, future interests that are not fully vested are excluded from the calculation of noncharitable assets.[38] Thus, if a foundation has options that are not fully vested, they should be considered mere future interests and should not be included in the foundation's noncharitable assets until all of the contingencies expire.

Excess Business Holdings

A foundation, and all of its disqualified persons together, may own no more than 20% of the equity interest in a business enterprise.[39] Disqualified persons, for this purpose, include the foundation's board of directors. Stock options do not count as equity interests for this purpose.[40] However, if the foundation were to exercise and convert the options into stock, the foundation's stock holdings become an equity interest and an excess business holding. Accordingly, the foundation should dispose the options prior to exercise.

Jeopardizing Investments

Treas. Reg. § 4944 prohibits a foundation from investing in a way that is likely to jeopardize its ability to carry out its exempt purposes. The regulations provide only minimal guidance on what may constitute a jeopardizing investment. An issue could arise if, for example, a very large percentage of a foundation's assets were in one company's stock. Similarly, an issue could arise if a very large percentage of a foundation's assets consisted of vested and exercisable options in one company, and the foundation failed to exercise the options, sell the stock and diversify its investments.

Taxable Expenditures

Another general concern for private foundations is whether a particular expenditure constitutes a taxable expenditure under Treas. Reg. § 4945. A foundation's exercise of stock options would not be a taxable expenditure because it would be an expenditure to acquire investments (i.e., the stock) entered into for the purpose of obtaining income or funds to be used in furtherance of the foundation's charitable purposes.[41]

Conclusion

As unfair as it might seem, there is not a "magic bullet" that can be used to easily transform stock options into charitable gifts. In some sense, options are like retirement plans: There is a lot of money there, but it is hard to get.

All hope is not lost, however. As noted above, options can make good testamentary gifts. In addition, keep several other thoughts in mind.

First, options often represent substantial wealth. While the options themselves may not make the best gift asset, the existence of this "pot" of wealth should enable the donor to give other assets. Often, people with options will also have marketable securities that can be given. A simple recommendation may be "exercise your options and give some of the appreciated stock you currently hold in your brokerage account." The deduction from the gift of the appreciated stock can offset the income on the exercise, and the donor will be left holding the newly acquired shares with a fair market value cost basis. As an alternative, the donor can exercise the options over a period of years, and each year use a portion of the shares to fund a so-called "retirement" net income unitrust.

Second, proper financial and tax planning is essential for someone with options, and can create or save enough wealth to foster charitable giving (if done properly). People with options need to formulate an exercise strategy, addressing such issues as what options will be exercised and when, what shares will be sold and when, what tax and cash flow issues will be created, and how the options fit into the overall family wealth planning. Additionally, the exercise of NSOs will create compensation income to the employee; a gift in the same year of other highly appreciated assets (such as stock received from the prior exercise of an ISO) may be warranted. This type of planning must be integrated with the rest of the executive's financial, tax and estate planning, and may require the assistance of both tax counsel and a financial planner.

Third, many of these executives will embrace the notion of social capital, once it is explained to them. They often believe that much of their self worth stems from the fact that they are creative, hard working and successful individuals, and they are often not interested in turning their children into "trust fund babies." Work with them on the concepts of social capital and voluntary philanthropy, and many will agree that charity is the best use for their excess wealth.

[1] IRC § 422(d).

[2] IRC § 422(b)(6).

[3] IRC § 422(a)(1).

[4] IRC § 422(a)(2).

[5] IRC §§ 1221-1222.

[6] IRC §§ 55-59.

[7] IRC § 424(c).

[8] IRC § 422(b)(5).

[9] IRC § 170(b)(1)(C).

[10] Treas. Reg. § 1.421-8(c)(1).

[11] *Ibid.*

[12] IRC § 424(c)(1)(A).

[13] Treas. Regs. §§ 1.61-15, 1.421-6.

[14] IRC § 83(a)-(b); Treas. Regs. § 1.83-7.

[15] Treas. Reg. § 1.83-7.

[16] IRC § 83(b).

[17] Treas. Reg. § 1.83-7; PLR 9713012.

[18] Treas. Reg. § 1.83-1(c); PLR 9616035.

[19] Rev. Rul 98-21, 1998-18 IRB 7.

[20] Treas. Reg. § 1.83-7.

[21] PLRs 9737014, 9737015 and 9737016.

[22] PLRs 9737015 and 9737016.

[23] IRC § 691(1)(C); Treas. Reg. § 1.83-1(d).

[24] PLR 200002011.

[25] "Venture Capital for Charity," *Chronicle of Philanthropy*, August 13, 1998.

[26] IRC § 1032.

[27] Rev. Rul. 75-348; PLR 9335057.

[28] IRC § 4940.

[29] IRC § 4940(c).

[30] IRC § 4940(c)(4).

[31] Treas. Reg. § 53.4940-1(f)(1); *Zemurray Foundation v. U.S.*, 755 F.2d 404 (5th Cir. 1985).

[32] PLR 9411018; PLR 9411019.

[33] IRC § 4941.

[34] PLR 8315060.

[35] Treas. Reg. § 53.4946-1(a)(7).

[36] PLR 9411018; PLR 9411019.

[37] IRC § 4942.

[38] Treas. Reg. § 53.4942(a)-2(c)(2)(i).

[39] IRC § 4943. Equity interests generally include voting or ownership interests.

[40] Treas. Reg. § 53.4943-3(b)(2)(i).

[41] Treas. Reg. § 53.4945-6(b)(i).