CHARITABLE CONTRIBUTIONS OF RESTRICTED STOCK, OPTIONS, AND SIMILAR ASSETS

MATTHEW A. CLAUSEN

The situation: The startup company is finally going public (or being acquired, or experiencing some other liquidity event). The founders, along with dozens of early employees and investors, are finally holding valuable shares or options rather than mere "paper wealth." Having done well, many of them may be turning their thoughts to doing good with their newfound riches. Their most valuable asset is likely those same shares or options, so the obvious thing to do is transfer them to one or more charities. They may be hoping to avoid paying tax on the gains from selling the equity, and that a large contribution deduction will offset some of their taxable income (which may well be spiking in the year of the liquidity event).

This article addresses various issues to consider when a donor proposes to contribute restricted stock, stock options, or restricted stock units (RSUs) to charity.[1] These types of assets are typically held by insiders and early investors—founders, friends and family, venture capitalists, employees, and contractors—in start-up companies.

Contributions of appreciated assets generally

When a donor contributes an appreciated asset to a Section 501(c)(3) organization, the donor is normally not treated as having sold the assets, and therefore is not taxed on any appreciation of the asset while the donor held it. The donor is, however, treated as having contributed the full fair market value of the asset for purposes of calculating the charitable contribution deduction under Section 170. The deduction for property donated to a public charity is limited to 30% of the donor's "contribution base" for the year.[2] Amounts contributed in excess of this limitation can be carried forward and used in any of the five successive tax years.

If the donor has only held the asset for one year or less, or held it as other than a capital asset, the charitable contribution is reduced by the amount of gain the donor would have if he or she sold the asset.[3] This normally reduces the deductible amount to the donor's cost basis in the asset. In that case, the applicable limitation is 50% of the donor's contribution base, rather than 30%.

The first order of business for both parties is to make sure they understand the nature of the particular asset and the applicable restrictions.

Contributions of restricted stock

In general, the registered shares of a company that trades on a stock market are unrestricted, and sell-

MATTHEW A. CLAUSEN is an attorney at Adler & Colvin. He would like to thank Erik Dryburgh, also of Adler & Colvin, for his helpful comments on an earlier draft of this article.

ing or donating them is a simple matter of calling a broker.[4] But shares held by founders or earned by employees and other service providers are normally not registered shares, and are often received before the company "goes public." These shares can come with a variety of restrictions, which can affect not only their value but the advisability of giving or accepting them as donations.

Sources of restrictions. Stock restrictions arise from a number of sources, including federal securities laws, shareholder agreements, and lock-up provisions in connection with an initial public offering (IPO) or other significant corporate event. The term "restricted stock" is used broadly herein to refer to shares that are subject to any restriction on ownership or transfer. The most common sources of such restrictions are discussed below.[5]

Restricted shares may not be sold unless an exception applies to the sale.

Securities law restrictions. In general, all shares of corporate stock other than registered shares (that is, shares that have been sold to the public pursuant to a valid registration statement filed with the Securities and Exchange Commission (SEC)) are restricted under the Securities Act of 1933. In addition, shares held by "affiliates" of the issuing company are restricted as "control securities," even if they are registered shares that the affiliate acquired on the open market. Restricted shares may not be sold unless an exception applies to the sale.[6]

Shares held by founders and those paid to employees as compensation typically are not registered shares, and therefore are restricted under the securities laws. Therefore, if a charity accepts these shares as donations, it will have to find an exception under the Securities Act in order to sell them. The exceptions available will depend on a number of factors that are beyond the scope of this article. One common exception used to sell restricted securities is Rule 144, which allows sales provided that certain requirements are met with respect to the shares, including a holding period before transfer and limitations on the volume of shares that can be sold during specific periods.

Shareholders' agreement restrictions. Restrictions can also come from shareholders' agreements. Start-up companies typically have such agreements in place prior to their initial public offering, and all shareholders (later transferees as well as the founding shareholders) are bound by the agreement. Shareholders' agreements may contain all manner of restrictions, including terms that (1) limit the number of shares that each shareholder can sell in a particular period, (2) forbid transfer of shares to particular types of entities or outside a group of permitted transferees, (3) require a change in character of any shares that are transferred outside a particular group (for example, converting founder's stock from high-vote to low-vote when transferred outside the group of founders), and (4) granting the corporation or other shareholders a right of first refusal that prevents sale to outsiders without first offering them to insiders.

Lock-up agreement restrictions. Lock-up (sometimes called "market stand-off") restrictions are typically put in place by the broker during and after an IPO. Similar restrictions may be used before or after certain other significant corporate events. Lock-up agreements are designed to control the number of shares in the market immediately after the IPO, and thus reduce volatility during that time. It is important for the recipient charity to understand the status of IPO talks and learn whether and when lock-up restrictions are expected to apply to the shares to be donated.

Charity-side issues. From the charity's perspective, donations of restricted stock can raise several issues. Before agreeing to accept a donation of restricted shares, the charity should request and examine all the relevant documents, including any shareholders' agreements, lock-up agreements,

[1] This article assumes that the recipient of the donation will be a public charity described in Section 501(c)(3) and Section 509(a)(1), (2), or (3). All Section references are to the Internal Revenue Code of 1986, as amended.

[2] "Contribution base" means the taxpayer's adjusted gross income for the year, without regard to any net operating loss carry-backs. Section 170(b)(1)(G).

[3] Section 170(e)(1)(A).

[4] Donations of S Corporation stock raise additional issues and are outside the scope of this article.

[5] Adler & Colvin does not provide securities law advice. We include these fundamental concepts here as background only.

[6] Other restrictions may apply in addition to the general requirement that restricted securities cannot be sold without an exception to the Securities Act of 1933. For example, Section 16(b) of the Securities and Exchange Act of 1934 prevents certain insiders of a corporation from profiting from the purchase and sale of securities of the corporation.

[7] One potential issue is whether the donor's advisory privileges with respect to a donor-advised fund triggers or otherwise affects the aggregation rules for purposes of the volume limitation under Rule 144.

[8] Donating shares that the donor received upon exercise of an incentive stock option (ISO) raises additional donor-side tax issues that are discussed below.

[9] Section 170(e)(1); Reg. 1.170A-1(c)(1).

[10] Section 170(e)(1)(A); Reg. 1.170A-4(a)(1).

[11] The same rule would apply if the donor had held the stock as a non-capital asset; for example, as inventory by a dealer in securities. This is unlikely to be the case where the stock is restricted stock held by a founder or earned by an employee.

[12] Reg. 1.83-4(a).

[13] Section 83(f).

and other agreements that may restrict the transferability of the shares. This step important, and not only to confirm that the charity can receive the shares in the first place. The restrictions in these documents may also bind the charity once it holds the shares. Depending on the situation, the charity may also need to seek assurances from the donor's counsel, corporation counsel, and possibly its own securities counsel regarding these restrictions.

Initial transfer. Whether the donor can legally transfer the shares to the charity is ultimately the donor's issue, but it behooves the charity to conduct its own due diligence, including reviewing any agreements restricting the shares, and getting assurances from the donor and/or donor's counsel, as well as company counsel, that the shares can be transferred to and held by the charity.

Transaction complexity and costs. Separately from the question of whether the donor can legally transfer the shares to the charity, it is important to note such transfers are not as simple as transfers of publicly-traded stock. There can be significant transaction costs, especially where multi-party contracts such as shareholder agreements and lock-up agreements are involved. It may be necessary to draft and agree to lengthy transfer agreements, secure the agreement of other parties, amend existing agreements, and obtain opinions of counsel. Other steps may be necessary as well.

Of particular importance to charities that sponsor donor-advised funds is that the sponsor should not pay any costs that are properly the donor's. There is a possible argument, not yet tested in the courts, that any payment of the donor's costs by the sponsor amounts to an automatic excess benefit transaction under Section 4958(c)(2). Thus, for example, while it is appropriate for the sponsor to seek its own securities and tax-exempt counsel with respect to a donation of stock, the sponsor should not agree to cover the donor's attorney fees and other costs associated with the transfer.

Holding and voting the shares. As described above, there may be agreements in place that affect the transferability of the shares. There may also be agreements, such as voting trusts, that affect who can vote certain classes of shares. The charity should be wary of any donation of voting shares that restricts or eliminates the charity's (or the charity's transferees) voting rights. Such a limitation could reduce the value of the shares in the hands of the charity and make them harder to sell, and has the potential to cause friction between the charity and whoever holds the voting rights.

Selling the shares. Any restrictions that limit the charity's ability to freely sell the shares (whether as to volume, timing, or permitted purchasers) may make liquidating the shares harder, and may reduce the amount the charity can expect to receive for the shares. Restrictions from any of the above sources could have this effect. If the charity plans to sell any shares that are restricted under the securities laws (that is, any shares that are not registered), it should seek securities law advice for purposes of finding an exception to the registration requirement, and should keep in contact with the donor if the donor's personal sales of shares may affect the charity's ability to liquidate during the same period (as may be the case if selling under Rule 144, for example).[7]

If the corporation undergoes an IPO or other corporate event while the charity is holding restricted shares, those shares may become subject to a lock-up agreement, preventing or limiting the sale of the shares for a specified period. Thus, the charity should stay apprised of the activities of any corporation in which it holds, or is considering holding, stock.

Donor-side issues. Aside from the initial question whether the shares are restricted in any way that would prevent them from being transferred to the charity, there are a number of other issues that affect the donor's treatment of the contribution.[8]

Amount of deduction. A donor generally can take a deduction equal to the fair market value (FMV) for a charitable contribution of property to the charity.[9] The deduction is reduced, however, by any amount that would not be long-term capital gain to the donor if the donor had sold the stock at its FMV on the date of donation, rather than donating it.[10] Therefore, the amount that the donor can deduct depends in part on whether the stock was held as a capital asset for more than one year. If the stock was held for one year or less, the donor can deduct only his or her cost basis in the stock.[11]

For shares earned as compensation, the holding period is affected by whether the donor made a Section 83(b) election upon receipt of the stock. If the election was made, the holding period began when the donor received the stock.[12] If not, the holding period did not begin until the donor's interest first became transferable or no longer subject to a substantial risk of forfeiture, whichever happened first.[13] The difference in holding period can be significant, so it is important for the donor giving shares earned as compensation to confirm with his or her tax advisor whether there is a Section 83(b) election in place for the shares to be donated.

For charitable deduction purposes, FMV is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[14] The FMV of donated stock, and thus the amount of the donor's deduction, will likely be reduced if the charity cannot freely sell the stock, or if any restrictions otherwise reduce the amount the charity can receive in selling the stock. These issues should be addressed by the donor's appraiser, as discussed below.

Founders and other insiders of start-ups often want to donate shares of their company without losing control. However, a donor generally cannot take a deduction for donating voting stock if he retains the right to vote the shares. The IRS considers this to be a donation of a partial interest and not deductible.[15] On the other hand, the IRS has allowed the deduction when the donor of voting shares had previously transferred the voting rights to another person for valid business reasons.[16] If a donor suggests a transaction in which the charity would receive voting shares but not the right to vote them, the charity should advise the donor to confirm with his or her tax advisor whether the partial interest rule will apply to disallow the deduction.

Finally, as described above, the donor will only be able to deduct the amount of the donation to the extent of 30% of his or her contribution base, with any unused excess carried forward to the following five years.

Timing of deduction. The charitable deduction is available in the tax year during which the contribution is "actually paid," meaning the date the shares are delivered to the charity.[17] Delivery is complete when the endorsed share certificates are delivered to an agent of the charity or when the certificates are placed in the mail.[18] If the transfer is conducted through the issuing corporation, the donation is not complete until the issuing corporation enters the transfer on its books--not when the donor gives instructions for the transfer to occur.[19] This distinction can be crucial if the transfer will be completed near the end of the donor's tax year and the donor is expecting a deduction in that year. Transfers of restricted shares can be complex and involve multiple parties—and multiple sets of attorneys—and completing the donation may take longer than anticipated. The charity should flag this issue for a donor who proposes to contribute restricted stock near the end of the year.

Substantiation. To take an FMV charitable contribution deduction, the donor must comply with several recordkeeping requirements to substantiate the gift and its value.[20] This article does not address all the substantiation requirements, and the charity should encourage donors to seek their own tax advice regarding the deductions they can take and the necessary substantiation in each case. The author notes one key substantiation requirement, however. For donations of property over $5,000, the donor must have a qualified appraisal of the property.[21] Qualified appraisals of the stock of privately held corporations can be costly and difficult to obtain. The appraisal can be done as early as 60 days prior to the donation, or any time after the donation until the due date of the tax re-

[14] Reg. 1.170A-1(c)(2).

[15] Rev. Rul. 81-282, 1981-2 CB 78 (right to vote shares is a property right; transfer of shares while retaining voting right is a nondeductible donation of a partial interest).

[16] See Ltr. Rul. 200108012. Private letter rulings cannot be relied on as legal precedent, but they are useful in gaining an understanding of how the IRS has dealt with particular situations in the past.

[17] Regs. 1.170A-1(a), (b).

[18] Reg. 1.170A-1(b).

[19] *Id.*

[20] See Section 170(f)(8); Regs. 1.170A-13(b), (c).

[21] The requirements for a "qualified appraisal" are laid out in Reg. 1.170A-13(c)(3).

[22] Reg. 1.170A-13(c)(3)(i)(A).

[23] Regs. 1.170A-13(c)(1)(i), (7)(xi).

[24] Reg. 1.170A-13(c)(7)(xi)(C)(1).

[25] See, e.g., Ltr. Rul. 9435007 (stock was qualified appreciated stock (QAS) in hands of private foundation that was not an "affiliate" of the issuer, where donor and foundation agreed not to act "in concert" for Rule 144 purposes in selling their respective stock), Ltr. Rul. 9441032 (stock was QAS where donor agreed (1) not to dispose of any stock to the extent such disposition would limit foundation's ability to sell donated stock and (2) to obtain, at donor's expense, opinion of counsel that any future proposed disposition of stock by foundation would qualify under Rule 144). The definition of "publicly traded securities" under the appraisal regulations is analogous to the definition of QAS. See *Todd,* 118 TC 354 (2002) (treating the two definitions as coextensive). These and other private letter rulings arising in the context of donations of QAS to private foundations are helpful in understanding how restricted stock may nevertheless qualify as publicly traded securities.

[26] See, e.g., *Palmer,* 62 TC 684 (1974) (donor did not recognize gain when donating stock to foundation, where corporation, under donor's control, redeemed the foundation's stock the following day), *acq.* Rev. Rul. 78-197, 1978 CB 83 (IRS acquiescence only if the charity is not legally compelled to surrender the shares).

turn on which the deduction will be taken.[22] As noted above, the primary issue for the appraiser will be the valuation reduction, if any, caused by the restrictions on the stock.

There is an exception to the appraisal requirement for publicly traded securities for which market quotations are "readily available on an established securities market."[23] This exception does not apply to any securities "subject to any restrictions that materially affect the value of the securities to the donor or prevent the securities from being freely traded."[24] Therefore, a donation of restricted shares normally will not qualify for the exception. However, if the donor is giving restricted shares of a corporation that is traded on an established market, the donor may be able to avoid the appraisal requirement if the restrictions do not "materially affect" the value of the shares or prevent the charity from freely selling them.

It is sometimes possible to structure contributions of restricted stock to qualify for this exception. For example, if the restriction preventing the free transfer of the shares is a volume limitation—whether under Rule 144, a shareholders' agreement, or some other source—the donor may be able to take steps that would bring the shares within the definition of publicly traded securities. By limiting the amount of the restricted stock held by the charity at any one time, and/or agreeing to restrict any personal sales of the stock that would impinge on the charity's ability to sell the donated shares in any given period, the restrictions on the charity's shares may be minimized to the point where they would not materially affect their value or marketability.[25]

If an appraisal will be obtained, the charity should not pay for it. The qualified appraisal is a requirement for the donor's taking the FMV deduction, and is thus properly an expense of the donor. As described above, the charity should avoid paying expenses that could rightfully be thought of as the donor's expenses to avoid any chance of an automatic excess benefit transaction.

Pre-arranged sale issue. As described above, the general rule is that the donor does not recognize the built-in gain when donating appreciated property to charity. This is the main incentive for donating appreciated property as opposed to cash. This rule does not apply, however, if the charity will be legally compelled to sell or otherwise dispose of the stock according to an arrangement made prior to the donation.[26] In such a case, the donor is treated as though he or she had sold the stock for the purchase price—thus recognizing the gain—then donated the resulting cash. The donor will still receive a deduction based on the FMV of the stock, but having to recognize the gain will erase some or all of the tax benefit of the deduction.

This "pre-arranged sale" issue may arise in the context of tender offers and redemptions of the donated stock, or where the donor has entered into a binding contract to sell the stock to a third party before donating it, giving the purchaser the right to purchase the stock from the charity. Thus, it is important for the donor to understand that any pre-arranged sale or other legal compulsion on the charity to sell the shares could reduce or eliminate the tax benefits of making the donation.

Restrictions on other holdings. There may be implications of transferring the shares to the charity that affect the donor's other holdings of the same stock. For example, if the donor is subject to a volume limitation on sales under securities laws or a shareholders' or other agreement, the donor may be required to aggregate sales by the charity with his or her own sales for purposes of the limitation. If this is the case, sales by the charity could limit the sales that the donor can make in a specific period. It is important for a donor to seek his or her own legal advice and fully understand any such restrictions before donating the stock.

Stock options

When considering a contribution of stock options, it is essential to know what type of options the donor intends to give.

Key concepts. 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 often the FMV of the stock at the time the option is granted. The employee's ability to exercise the option typically is deferred until some time in the future, and is 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.

For tax purposes, stock options can be classified as either statutory stock options (SSOs), so called because they meet the requirements for favorable federal income tax treatment under Section 421, or non-statutory stock options (NSOs), also sometimes called non-qualified options. NSOs are not subject to the favorable tax treatment of SSOs, but are generally more flexible. Statutory stock options include incentive stock options (ISOs), as described in Section 422(b), and options granted under a qualifying employee stock purchase plan as described in Section 423(b) (a "423 plan"). ISO plans and 423 plans each must meet a number of stringent requirements, making these types of options generally less common than NSOs.

Before discussing the donation of options, the charity and the donor must review the terms of the stock option plan or agreement to determine whether a transfer of the option itself is even possible. SSOs generally are not transferrable during the life of the employee, and therefore will not normally be received by the charity other than by bequest. Even many NSO 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. The employee 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 executives' holdings.

Below is a brief discussion of the tax consequences to the employee of receiving, holding, and exercising SSOs and NSOs. Because of these rules, donations of SSOs and NSOs are generally either impossible or unfavorable, and therefore the charity is unlikely to receive many donations of options. However, because these rules also affect donations of the stock an employee receives after exercising SSOs or NSOs, it is important for the charity to be aware of them. Finally, as discussed below, both SSOs and NSOs may be contributed to the charity at death without some of the negative effects of *inter vivos* contributions.

Statutory stock options (SSOs). SSOs are generally favorable from a tax perspective, but are subject to significant restrictions.

Tax treatment. The employee does not recognize income upon either the receipt or the exercise of an SSO, provided the requirements discussed below are satisfied. SSOs are thus attractive to the employee, who pays no tax until he or she finally sells the shares of stock received from the exercise.[27]

To obtain the favorable tax treatment, the shares 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.[28] Also, the employee must remain an employee of the granting company (or a parent or subsidiary of, or successor entity to, the granting company) throughout the period from the date the option is granted through the day three months prior to its exercise.[29] At that point, the shares are a long-term capital asset to the employee.[30] Accordingly, the employee will be taxed only when he or she eventually sells the shares, and then only at capital gains rates. The gain is calculated as sales price minus basis (which is the option price paid at exercise).

If the employee disposes of the shares prior to satisfying the holding period, the favorable

[27] ISOs, but not 423 plan options, receive slightly less favorable treatment for alternative minimum tax (AMT) purposes. A detailed discussion of AMT consequences is beyond the scope of this article. Generally, the employee will include the difference between the option price and the FMV of the stock on the date of exercise in the calculation of his or her AMT, even though this event is ignored for regular tax purposes. Section 56(b)(3). As a result, employees may find themselves paying AMT in the year of exercise. The employee's tax basis in the shares (for AMT purposes only) will be equal to the FMV of the shares on the date of exercise, and therefore the employee will have less gain (or more loss) for AMT purposes than for regular tax purposes upon the later sale of the shares. *Id.* Any AMT paid by the employee at exercise is carried forward as a credit, which can be used against the donor's regular tax in future years to the extent that regular tax exceeds AMT. Section 53(a). The actual impact to a particular individual can be determined only upon a review of his or her entire tax situation, and charities should encourage all donors to consult their own tax advisors to review the implications of any planned donation.

[28] Sections 422(a)(1) (for ISOs) and 423(a)(1) (for 423 plan options).

[29] Sections 422(a)(2) (for ISOs) and 423(a)(2) (for 423 plan options).

[30] See Sections 1221, 1222.

[31] Section 421(b); Reg. 1.421-2(b)(2).

[32] Section 424(c).

[33] Sections 422(b)(5) (ISOs) and 423(b)(9) (423 plan options). See the discussion below regarding bequests of SSOs.

[34] See note 27, *supra*.

[35] Reg. 1.421-2(c)(1).

[36] *Id.*

[37] Section 2055.

[38] Section 424(c)(1)(A).

[39] Sections 83(a), (b); Reg. 1.83-7. In some cases, the holder of 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. See generally Section 83(b) and Reg. 1.83-2.

[40] Generally, an option is treated as not having a readily ascertainable FMV unless it is publicly traded on an established securities exchange. Reg. 1.83-7(b).

[41] Reg. 1.83-7.

[42] Reg. 1.83-7; *Weigl,* 84 TC 1192, 1219 (1985) (charitable contribution is not an "arms-length transaction" for purposes of Reg. 1.83-7).

tax status is lost. The employee will, in the year of the disposition, recognize compensation income equal to the difference between the fair market value of the stock at the time of exercise and the strike price paid upon exercise; in addition, any appreciation in the shares from the date of exercise to the date of disposition will be a capital gain.[31] For this purpose, the term "disposition" includes almost any transfer of legal title, including a gift.[32]

Contributing SSO shares. As mentioned above, SSOs cannot be transferred other than by will.[33] As a result, an employee cannot transfer an SSO to the charity during his or her lifetime. Thus, a prospective donor with SSOs will have to either donate other assets or exercise the SSOs and donate the resulting shares.

A donation of SSO 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, the charity should not recommend a donation of SSO shares unless the donor is sure that the shares have been held for the requisite time period.

Once the employee has held the SSO 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, as discussed above, can be used to offset up to 30% of the employee's adjusted gross income. Because capital gain is generally not recognized on donations, a charitable donation of shares can be an attractive alternative to a sale. The donor should review with his or her own tax advisor whether donating the SSO shares is the most attractive alternative, especially if they were from exercise of ISOs, given the potential benefit of the higher alternative minimum tax basis in those shares.[34]

Finally, as with any donation of shares not acquired on the open market, the charity and the donor should evaluate whether and what restrictions apply to the SSO shares as discussed above.

Bequeathing SSOs and SSO shares. The favorable tax treatment applicable to SSOs is not lost upon the death of the employee. The option plan may allow the option to be exercised by the employee's estate or the beneficiary who acquires the option by bequest. The employee's estate or the beneficiary will enjoy the same tax treatment on exercise as the employee would have.[35] Further, there is no requirement that the estate or beneficiary exercise the option within three months of the employee's death.[36] Bequeathing SSOs to the charity will also generate a charitable deduction against the estate tax.[37]

If an employee exercises an SSO and thereafter dies, the transfer of the SSO shares to the estate or beneficiary is not a "disposition" of the shares, and does not trigger tax.[38] The recipient "steps into the shoes" of the decedent/employee and benefits from the favorable tax treatment. Bequeathing SSO shares will also generate a charitable deduction against the estate tax.

Non-statutory options (NSOs). NSOs, though less restricted than SSOs, can present problems for donors and charities.

Tax treatment. NSOs received by employees as compensation are generally subject to taxation as income upon either (1) the initial grant to the employee if the option has a readily ascertainable FMV at that time or, if not, then (2) when the NSO is exercised or "otherwise disposed of."[39] NSOs held by employees typically do not have a readily ascertainable value on the date of grant, and the employee will be subject to tax only at the time of exercise.[40] In that case, the income upon exercise of the NSO will be the difference between the FMV of the stock at the time of exercise and the exercise price (generally the FMV of the stock at the date of the grant), and will be taxed as ordinary income. At that point, the employee holds stock with a basis equal to its FMV on the date of exercise and a holding period that begins at 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.[41]

Contributing NSOs and NSO shares. Unlike SSOs, an employee can transfer NSOs during life, provided the individual stock option plan or agreement permits. Some plans allow transfers to family members or trusts for family members. Some enlightened companies have plans that allow transfers of NSOs to charities as well. Even if the employee's 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.

The donation of an NSO to the charity does not trigger any income to the donor.[42] However, there may be no advantage to donating the option rather than exercising it and donating the stock or cash instead. Moreover, donating the option can have troublesome effects that must be considered. NSOs are deemed to generate compensation income to the employee whenever they are exercised or disposed of in an arm's-length transaction—even if the charity is the party that exercises or sells them. That makes for a potential timing difference between the deduction, taken when the donation is completed, and the recognition of income, which may come much later.[43] Moreover, there is a risk that the donor's deduction will be reduced to his or her basis in the NSO (rather than its FMV) under Section 170(e).[44] For these reasons, it is essential that the donor and his or her tax advisor carefully consider whether donating NSOs to the charity is the most tax-efficient way to make the desired donation.

Once the employee exercises the NSOs and holds shares, a donation 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. Because capital gain is generally not recognized on donations, a charitable donation of shares can be an attractive alternative to a sale. Finally, as with any donation of shares not acquired on the open market, the charity and the donor should evaluate whether and what restrictions apply to the shares.

Bequeathing NSOs and NSO shares. Although an *inter vivos* donation of NSOs is not particularly advantageous, a testamentary transfer of NSOs to charity may provide some real benefits to the donor. Any gain recognized upon the subsequent exercise of the NSOs will be deemed "income in re-

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spect of a decedent" (IRD) and included in the gross income of the person or entity that receives and exercises the option.[45] Also, like retirement plan assets, stock options do not receive a stepped-up basis at death.[46] Because of these rules, 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. The combined tax rate on such a gift can be very high. The IRS, however, has ruled that if an NSO holder bequeaths his options to a charity and the charity later exercises the options, the income will be IRD to the charity and not to the donor's estate.[47] Because of the charity's tax-exempt status, the IRD will escape taxation. The IRS also confirmed that the donor's estate is entitled to a charitable deduction against the estate tax for the value of the NSOs. Thus, bequeathing the NSOs to the charity can completely avoid both estate and income tax, resulting in every penny going to charity.

Restricted stock units

Some companies compensate employees with restricted stock units (RSUs) rather than with actual stock or options. An RSU is a commitment by the employer to transfer stock to the employee on a given date in the future, provided the employee is still employed by the issuer at that time. The employee does not receive the stock until the vesting date. RSUs cannot be transferred to a charity because they are mere promises for future compensation—like a bonus that will be earned at some point in the future. Once the RSU has vested and the employee receives the shares, the normal rules discussed above for donations of shares apply. The charity and the donor should strive to understand what restrictions, if any, apply to the resulting shares.

Conclusion

Restricted stock and related equity instruments can be excellent choices for charitable contributions, but they can also hide traps for the charity, the donor, or both. The first order of business for both parties is to make sure they understand the nature of the particular asset and the applicable restrictions. Only then can they begin to assess the tax and practical implications of the proposed contribution. ■

[43] Further complicating this issue is Rev. Rul. 98-21, 1998-1 CB 975, in which the IRS ruled that, for gift tax purposes, a gift of an NSO was not complete until the later of (1) the transfer or (2) the vesting of the option. By analogy, a donation of unvested NSOs to a charity may not be a completed donation until the NSOs vest.

[44] This result would occur if the donation was complete in one tax year, but the charity waited until a later tax year (of the donor) to exercise or dispose of the options. In that situation, the donor has contributed property that would not generate long-term capital gain if sold, and therefore Section 170(e) would apply to reduce the deduction to the donor's basis. If the contribution and exercise or other disposition occur in the same tax year, an exception applies that should permit a full FMV deduction. See Reg. 1.170A-4(a).

[45] Section 691(a)(1)(C); Reg. 1.83-1(d).

[46] Section 1014(a)(1).

[47] Ltr. Rul. 200002011.