



Stock Options: Estate, Tax and Financial Planning

Carol Cantrell

2009 Edition



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Stock Options: Estate, Tax and Financial Planning

2009 Edition

Carol A. Cantrell
Briggs & Veselka Co.

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ISBN: 978-0-8080-9205-6

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Portions of this work were published in a previous edition.

Printed in the United States of America

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Preface

This book contains the only complete cradle-to-grave discussion on the market today of all the tax, estate, and financial issues that confront a person with stock options. I was inspired to write it after a client, for whom I had just completed a 20-year cash flow projection, died suddenly of cancer at the age of 57. He left behind his wife who was a schoolteacher, his two college-bound children—and four million dollars of unexercised stock options. None of his advisors knew what to do. This able group included his investment manager, his lawyer, trust officer, and the human resources administrator at his company. Instead, they all looked to me, his CPA, and I wasn't sure where to start. There were so many questions and so few answers.

Because of that experience, I created this single-source reference guide, which provides comprehensive, up-to-date information on the major tax and financial areas affecting stock options. It offers practical advice for dealing with options through its many examples, planning notes, and forms designed for a quick understanding and easy application of the principles. Many of the examples are based on real-life client problems with the names changed to protect their identity.

The subject areas involved span across many professional disciplines. Therefore, most practitioners will be familiar with some, but not all of the areas. But their clients with stock options will encounter the majority of these issues at some time during their lives. For many of them, stock options are their largest and most important asset. Therefore, this book attempts to fill the educational gaps for the practitioner and his client where answers are to be had. And where questions remain unresolved, it offers useful suggestions and a good starting point for further research.

With the recent focus on executive compensation, FASB's mandate to expense options, and Congress's strict new deferred compensation rules under Section 409A, the latest edition of this comprehensive treatise is a must for any professional who advises on stock options. This includes tax accountants, estate planners, human resources consultants, divorce attorneys, and individuals themselves who have stock options. Whether you practice on Elm Street or Wall Street you should have this book in your library.

Because of the rapidly changing nature of taxes and numerous other laws affecting the securities and financial markets, there will necessarily be many updates to this book. And because I want it to be as useful as possible, I encourage readers to let me know how I might improve it.

Carol A. Cantrell
Houston, Texas
September 2008

Acknowledgments

I am grateful to the many people who have helped me in their own special way to write this book. I particularly appreciate my loving and wonderful husband, Pat Cantrell, whose mentoring has been the source of my inspiration for twenty-six years of marriage, and still counting. I am eternally grateful to my daughter Emily, who majored in English at Emory University, and my office assistant, Julia Mather, for their invaluable secretarial assistance. I also wish to thank my daughter Becky, a Ph.D. candidate at Cornell University, who explained the Black-Scholes formula to me. And finally, I thank all my friends, colleagues, and clients who have brought me their most difficult stock option questions to resolve over the years. They have helped me more than they know.

About the Author

Carol Ann Cantrell was born in Montmartre, Saskatchewan, Canada on May 13, 1952 while her father was temporarily employed there in search of oil. The family moved back to the United States in 1958 where Carol attended high school and graduated cum laude from the University of Texas in Austin with a Bachelor of Arts in mathematics. She began her career in public accounting in 1974 with Ernst & Young (formerly Arthur Young & Co.), and left there after becoming a CPA to form her own accounting firm in 1976. She has been self-employed since that time with her husband as her partner. Self-employment allowed her the flexibility to work full time while raising her three children.

Carol and her husband merged their practice with Briggs & Veselka Co. in 2000 to become the largest local CPA firm in the Houston area. At the firm, Carol concentrates on tax and financial planning for corporate executives, families, retirees, and the elder population. She specializes in stock options, trusts, partnerships, and estate taxes. She is also a frequent speaker for Texas legal and accounting organizations, national societies, and financial planning groups. She has published numerous articles in magazines and trade journals on income taxation of partnerships, estates, trusts, and individuals.

At the age of 48, Carol fulfilled a lifelong goal and began law school at the University of Houston Law Center. It was during her years in law school that she wrote this book. She graduated cum laude in 2003, passed the Texas bar in 2004 and is admitted to practice law in Texas, the United States Tax Court, the United States Court of Appeals for the Second and Fifth Circuits, and the United States Supreme Court. She looks forward to updating this book every year as new developments unfold that affect stock options.

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§ 1.01 INTRODUCTION

Stock options offer millions of employees a way to share in their company's wealth without costing the employee a dime. This opportunity occurs because an option

holder has a contractual right to acquire the stock at a fixed price for a fixed period of time determined up front. The employee can then sit back and wait, during the entire option term if they like, before exercising the right to buy the stock. Then when they are ready, they can enter into a cashless exercise by selling just enough shares to pay the cost and pocket the difference. This golden wait-and-see opportunity can last as long as ten years under most contracts. Perhaps best of all, when they cash in the stock, they can do so at favorite capital gain rates and incur no employment taxes. Simply stated, options offer employees a risk-free way to participate in their company's growth with the maximum amount of leverage and a minimum amount of taxes.

Options are a favorite with employers and shareholders too, but for different reasons. Broad-based stock and option grants motivate employees, give the employer a competitive edge in hiring, and clamp on a pair of golden handcuffs that requires no cash outlay. Surveys show that companies with broad-based stock options programs outperform companies without them.¹ Logically, anything that increases employee performance and costs the company nothing should have a positive impact on the stock value. Yet, all these remarkable features have made stock options a frequent topic of debate all the way from the water cooler to Wall Street.

So what are they talking about? There is plenty. Even before stock options made front page news amidst the accounting scandals and Financial Accounting Standards Board's (FASB) requirement to expense them, they were a curiosity in the tax, accounting, and investment world. This is partly because they are a study in contrasts. For instance, they are universally regarded as compensation, yet they cost the employer nothing. But, unlike ordinary compensation, they are taxed at capital gain rates. Although they are private employment contracts, they are subject to rigorous state and federal securities restrictions. Thus, they have features characteristic of both investment assets and earned income. Yet, these valuable instruments will expire if left untended. The unique features of stock options have spawned a number of questions over how and when they are taxed, valued, and recorded for financial statement purposes. Disputes also arise over what government entity has jurisdiction to tax them,² who has a legitimate claim to them in death,³ divorce,⁴ and bankruptcy,⁵ and whether they can be transferred at all.⁶

This publication answers these questions and many more. In addition, it raises many questions for which there are no clear answers. It is intended to be a comprehensive guide for estate, tax, and financial planners who advise clients about employee stock options, human resources personnel who are presumed to know all about these important benefits, and for insiders who cannot afford not to know these things. Finally, it is also for the inquisitive-minded individual who wants to maximize the value of his or her stock options in a number of different life circumstances.

§1.01 ¹ *ESOPS, Broad-Based Stock Options, and the Stock Market*, Employee Ownership Report, NCEO, Vol. XXIV No. 1 (Jan/Feb 2004), p.7.

² See Chapters 12 and 14 for a discussion of foreign and state taxation of stock options.

³ See Chapter 10 for a discussion of stock options in estate administration.

⁴ See Chapter 7 for a discussion of stock options in divorce.

⁵ See Chapter 8 for a discussion of stock options in bankruptcy.

⁶ See Chapters 2 and 5 for a discussion of the transferability of stock options.

§1.02 EVOLUTION OF OPTION COMPENSATION

Companies have used options to compensate their employees for a very long time. Indeed, options have had a dramatic and colorful history. Employee stock options began as a way to motivate the rank and file with tax-favored benefits. Yet somehow they wound up in the center of controversy over boardroom scandals.

[A] *Statutory Stock Options*

The earliest form of tax-favored compensatory options was restricted stock options, ushered in by the Revenue Act of 1950. These early options resembled today's incentive stock options in many ways. They were not taxable on the exercise date and afforded capital gain treatment when the stock was sold. However, they had no holding period requirement. Restricted stock options lasted about 14 years until the Revenue Act of 1964 abolished them and replaced them with qualified stock options, which required a three-year holding period. But, like their predecessors, they too were abolished after about 12 years by the Tax Reform Act of 1976. Stock options as we know them today were introduced in 1981 by the Economic Recovery Tax Act.¹ This in-and-out-again history of tax-favored stock options left behind a patchwork of regulations that is still used for guidance today.²

[B] *Nonstatutory Stock Options*

The nontax-favored variety of stock options, usually referred to as nonstatutory or nonqualified, owe their tax origin to the 1956 United States Supreme Court decision of *Commissioner v. LoBue*.³ In that case, the Supreme Court held that nontransferable, nonstatutory stock options granted to an employee for services rendered were taxable when exercised. Prior to that time, employees attempted to report them on the grant date as having very little value, especially when the exercise price was the same as the market value on the grant date.⁴ Employers, on the other hand, favored reporting the compensation expense when the employee exercised the options, when the compensation expense gave the employer a larger deduction.⁵ The *LoBue* holding formed the basis for Regulations Section 1.421-6 promulgated in 1959, which contained the rules for taxing nonstatutory stock options.⁶ In 1969, language substantially identical to that regulation

§1.02 ¹IRC §422A, Pub. L. No. 97-34 (Economic Recovery Tax Act of 1981), redesignated as IRC §422 by the Omnibus Budget Reconciliation Act of 1989 (OBRA'89), Pub. L. No. 101-508.

²See Preamble to the Final Regulations on Statutory Options, T.D. 9144 (Aug. 2, 2004) for a history of the regulations published under IRC §§421, 422, and 424 since 1957.

³351 U.S. 243, 249 (1956) (options granted an employee to purchase stock of his corporate employer yielded taxable gain which "should be measured as of the time the options were exercised").

⁴*Comm'r v. Stone's Estate*, 210 F.2d 33 (3d Cir. 1954).

⁵*Union Chem. & Materials Corp. v. United States*, 296 F.2d 221 (Ct. Cl. 1961).

⁶Reg. §1.421-6, T.D. 6416, 24 Fed. Reg. 7724 (Sept. 24, 1959).

was incorporated into IRC Section 83, which governs the taxation of all forms of property, including options, received for services rendered.

[C] *Intrinsic Value Under APB Opinion Number 25 and FIN 28*

Stock options and other forms of equity-based compensation began to grow steadily during the 1970s and 1980s. At that time, APB Opinion Number 25 only required companies to record compensation expense for options with an exercise price that exceeded the market value on the grant date.⁷ Therefore, since most companies issued options with an exercise price equal to the market value on the grant date, companies effectively recorded no compensation cost for options. As option plans became more complicated, the Financial Accounting Standards Board (FASB) also issued FIN Number 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, to provide additional guidance under APB Opinion Number 25.⁸ FIN Number 28 covered the accounting treatment for stock appreciation rights (SARs) and other variable stock-based awards. Variable awards are those for which the number of shares the employee may receive, the price per share the employee must pay, or both are unknown on the date of the grant or award. FIN No 28 specifically identified SARs as variable awards and required companies to adjust the compensation expense annually for these types of awards to reflect changes in the quoted market price of the stock.

[D] *FAS Number 123 Introduces Fair Value*

FASB was still displeased by the inadequate disclosure on companies' financial statements regarding the true cost of stock options. In June 1993, FASB issued an exposure draft that required companies to record compensation cost using fair value for all stock-based compensation awarded after December 31, 1996. Fair value for options means a measurement based on an option pricing model like Black-Scholes.⁹ FASB's exposure draft was met with great controversy and criticism from many fronts. Mostly, critics feared that it would cause dire economic consequences for small- and medium-sized companies if they had to expense stock options using an option pricing model like Black-Scholes.

Therefore, after considerable compromise, FASB's Statement of Financial Accounting Standards Number 123 (FAS 123), emerged in 1995 as a much watered-down version of the original. It establishes *fair value* as the method of accounting for stock-based compensation plans.¹⁰ However, FAS 123 merely

⁷ Accounting for Stock Issued to Employees, Accounting Principles Board No. 25 (Accounting Principles Bd. 1972).

⁸ Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, Financial Interpretation No. 28 (Financial Accounting Standards Bd. 1978).

⁹ See § 5.04[B][2] *infra* for discussion of the Black-Scholes option pricing model.

¹⁰ Accounting for Stock-Based Compensation, Statement of Financial Accounting Standards No. 123, Appendix A, ¶ 1 (Financial Accounting Standards Bd. 1995).