



Stock Option Gains — A Technique For Deferring Taxation

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Financial institutions and their holding companies have relied increasingly on stock options to compensate their officers, directors and employees and as a way to better link pay to performance. In doing so, many of these organizations have granted non-qualified stock options that expire within ten years of the grant date. Though non-qualified stock options work well as a compensation tool, they have an inherent drawback: the optionee recognizes taxable income when the option is exercised.

As a stock option nears expiration, an optionee faces the prospect of a significant tax liability on the difference between the fair market value of the stock underlying the option and the option exercise price. If all has gone as planned since the options were granted, the company's stock price has risen dramatically since the stock option grant date, and the optionee must be prepared to write a large check to the IRS when the option is exercised. Another possibility is that an officer, director or employee may need to exercise a non-qualified stock option long before the ten year term runs. For instance, an exercise may be necessary if the optionee's employment or service as a director terminates and the stock option plan provides a short window, say 90 days, for exercising stock options after termination, or a pending merger or other business combination cuts short the life of the option. All of these situations justify consideration of tax deferral techniques

We have been recommending that our financial institution clients consider a method that would allow an optionee to defer recognition of taxable income in connection with the exercise of non-qualified stock options. This approach is especially important for financial institutions that have granted non-qualified stock options with a term that will expire in the next few years or options that an optionee, for a variety of reasons, may want to exercise years before the term of the option ends.

How The Transaction Works

To qualify for the tax deferral, the stock option plan and a related deferred compensation plan must permit the deferral of the stock option gain. The optionee makes an advance election to defer receipt of the gain until a specified future time, such as termination of

employment or age 65. The optionee exchanges previously-acquired shares of company stock held for at least six months, and having a fair market value equal to the exercise price, in satisfaction of the option price. The realized gain, which is the excess of the fair market value of the option shares over the strike price, is retained by the

company, or by the trustee of a rabbi trust, until distribution to the optionee at the elected deferral date.

Income Tax Issues

IRS Revenue Ruling 80-44 indicates that exercising stock options using company stock to satisfy the strike price is a tax-free, like kind exchange, and that the shares received in excess of the shares tendered in exercise would be taxed as ordinary income upon receipt. The Ruling does not deal with the deferral of stock option gains. But a logical extension of the reasoning of the Ruling should permit treatment as a tax-free like kind exchange as to all of the shares received upon exercise of stock options if the stock option gain is deferred, pursuant to an appropriate advance election. The Ruling, however, does not deal with a cash exercise of an option, and a cash exercise raises the risk of constructive receipt of income to the optionee upon exercise of the option. The most common time for the advance deferral election to be made is six

months prior to the date of exercise. The deferral is not applicable to an incentive stock option since the exercise of such an option does not result in taxable income, except for alternative minimum tax purposes.

In the event of a successful deferral, the optionee recognizes no income until the deferred amount is distributed, and the company recognizes no tax deduction until that time. In addition, the company will be taxed upon any earnings attributable to the deferred amount during the deferral period. Upon distribution of the deferred amount, the optionee will recognize ordinary income and the company will receive a corresponding deduction. If the deferral had not been made, and the option stock had been acquired and held by the optionee, any subsequent appreciation would be taxed as capital gain when the stock was sold and no company deduction would have been realized. Accordingly, the deferral has the disadvantage to the optionee of converting any appreciation in the stock after the date of deferral from capital gain into ordinary income.

An Illustration

Assume an optionee owns 50 shares of company stock plus 100 non-qualified stock options at a strike price of \$10 per option. Also assume that the company's stock has a market price of \$20 per share. If the optionee exercises the 100 stock options in the normal course, the optionee will recognize \$1,000 of ordinary income on the date of exercise (i.e., \$2,000 less the \$1,000 aggregate strike price). If the optionee, however, avails himself or herself of the tax deferral technique explained in this paper,

recognition of the \$1,000 of ordinary income would be deferred. For instance, under the technique, the optionee would exercise the 100 options using the 50 shares of company stock he or she owns, since those 50 shares have an aggregate value equal to the aggregate option strike price of \$1,000 (*i.e.*, 50 shares at \$20 per share). Under this scenario, assuming the other conditions for use of the technique are observed, the optionee would not recognize ordinary income upon exercise. Instead, the value of the spread on 100 shares of company stock would be held by the company's deferred compensation plan for the benefit of the optionee. The optionee would defer taxation on the gain until the shares are withdrawn from the plan.

Accounting Issues

The most significant problems relating to the deferral technique involve accounting treatment. In order to avoid a current charge to the company's earnings, the exercise must occur with pre-acquired company stock held for at least six months prior to the exercise. In addition, the optionee can be allowed to defer the gain only into stock-related investment alternatives, and he or she must receive distribution in the form of company stock at the end of the deferral period. Accordingly, the deferral technique will work primarily with respect to an optionee who wishes to defer the gain applicable to an option that is about to expire or an optionee who may desire to exercise an option before its set expiration date due to, for example, termination of employment or service as a director or in connection with a merger or other business combination. An optionee using this deferral method must be willing to have the value of the deferred gain continued to be related to the value of company stock. The technique will not be attractive to an optionee who wishes to diversify his or her investment portfolio unless the company accepts the adverse accounting treatment.

Securities Issues

No significant issues arise in connection with the deferral technique under revised rules promulgated under Section 16 of the Securities Exchange Act of 1934, since the exercise of the option will be exempt from Section 16 if the option plan contemplates the exercise and deferral and the stock option agreement is approved by the company's board of directors or its compensation committee. The election to defer must be reported on SEC Form 4 or Form 5 and disclosed in the company's annual proxy statement.

Design Issues

The technique will require the amendment of the company's stock option plan to permit deferrals, and the creation of a new deferred compensation plan or the amendment of an existing plan. The revised or newly-established deferred compensation plan should set forth: (1) the time of the deferral election, (2) the length of the deferral period, (3) optional investment alternatives, if permitted, (4) the method of payout on deferral, and (5) the timing of a payout. Funding issues must also be considered. The use of a rabbi trust to fund the deferred obligation is permissible and, in some cases, may be advisable.

Advantages and Disadvantages

The deferral technique poses the following advantages and disadvantages:

1. Advantages:

- a. An optionee is provided with the opportunity to defer taxation of ordinary income otherwise recognized upon exercise of an expiring non-qualified stock option.
- b. An optionee is allowed to save for retirement or other significant financial expense.
- c. An optionee may diversify his or her investment portfolio if the company accepts adverse accounting treatment.
- d. Even if the term of stock options extends for many years into the future, some optionees may be forced to exercise their options prematurely due to termination of employment or service as a director. Likewise, if a merger is announced, optionees may desire to exercise their stock options early. In these cases, the technique described in this paper would allow optionees the flexibility of deferring taxable gains on their non-qualified stock options when premature exercise of the option becomes advisable.
- e. If a financial institution or financial institution holding company is acquired in a merger or other business combination, and if its stock options provide for the tax deferral technique explained in this paper, the seller may negotiate for the transfer of the technique to options of the acquiring company exchanged for options of the seller, if such exchange is part of the deal.

2. Disadvantages:

- a. The tax treatment is not certain. There is no specific IRS authority and IRS is unwilling to rule on the technique.
- b. Any appreciation in the value of the option stock after the date of deferral will be converted from capital gain to ordinary income recognized at the date of distribution of the deferred amount
- c. The deferral of the option gain represents an increased cost to the company due to deferral of the tax deduction and current recognition as taxable income of earnings on deferred amounts.
- d. Adverse accounting treatment will arise if an optionee is allowed to diversify investment alternatives or receive cash payouts.
- e. The deferred amount will be subject to the company's creditors.

Despite the disadvantages, the deferral technique is receiving considerable attention by companies and should be analyzed by financial institutions with respect to non-qualified stock options granted to optionees that are due to expire in the near future or stock options that may be exercised prematurely.

About the Author

Neal A. Mancoff has significant experience with all aspects of designing, drafting, and qualifying various types of qualified and non-qualified retirement plans for large corporate clients as well as privately held clients. These arrangements include defined benefit plans, profit sharing plans, Employee Stock Ownership Plans ("ESOPs"), Section 401 (k) plans, cash balance pension plans, money purchase pension plans, bonus plans, phantom stock plans, profit sharing plans, appreciation plans, and stock option and restricted stock plans.

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