

# Renaissance

## WHITE PAPER

### Can a Donor Contribute Employment Options to a Donor-Advised Fund?

Yes. The better – yet longer – question is, “Can the donor contribute employment stock options to a Donor-Advised Fund (DAF) and avoid the income and capital gain otherwise attributable to the option holder upon the exercise and sale of the options?” This White Paper will answer this question for two of the most common types of employment-related options. Those two types are incentive stock options (ISOs) and nonstatutory stock options (NSOs).

#### ***Incentive Stock Options***

An Incentive Stock Option (ISO) is not transferable;<sup>1</sup> that is, the options themselves cannot be contributed to a DAF. However, once the options are exercised by the employee, the *stock* can be transferred to a DAF. Normally, the holder of stock shares received via an ISO exercise will want to wait a minimum of one year<sup>2</sup> after the exercise before contributing them to a DAF. This minimum holding period serves a dual purpose. First, it turns the shares into a long-term capital gain asset. Second, and more importantly, the delay avoids a disqualifying disposition that would terminate the ISO status attributed to the shares. A second holding period that applies to ISOs is that the employee must hold a combination of the option and all of the exercised shares a minimum of two total years<sup>3</sup> before disposing the shares to maintain the ISO status. The third holding period requirement is that the employee

must maintain employment status with the company throughout most of the period.<sup>4</sup>

#### ***Nonstatutory Stock Options***

A Nonstatutory Stock Option (NSO) is sometimes also referred to as a NonQualified Stock Option (NQSO). Depending on the terms of the written option agreement, an NSO may be transferable, but the *employee* generally must recognize income<sup>5</sup> equal to the difference between the fair market value of the stock acquired and the option price. Generally, the employee recognizes income when the option is exercised. This is true, even if the employee transfers the option to the DAF, which effectively negates a major reason most people initially consider contributing the option to the DAF, namely to avoid the income tax liability associated with exercising the option.

However, like an ISO, the stock shares acquired after exercising the NSO can be transferred to a DAF. As a result, after the employee exercises the NSO (and recognizes income in the process), the shares are treated the same as shares purchased on the open market. After they have been held for more than one year, if the shares increase in value, they may be a suitable choice for funding a DAF.

#### ***Technical Considerations***

It is important to understand the exact nature of the options under consideration.

If you are unsure about what kind of options are owned, it is important to take the time to find out whether it is an ISO or an NSO.

Provisions common to both types of compensatory options are:

- An employment option is a right granted by an employer to an employee to buy stock from the company at a predetermined price.
- Generally, the option price (the price the employee must pay to acquire the stock) relates to the stock price when the option is granted.
- The option's terms and rights must be in writing.
- The option must continue for a specified period of time.
- No income is recognized by the employee when the company grants the option.
- The employee is not obligated to pay the option price until (s)he elects to exercise the option.
- The option can be exercised by the estate of a deceased optionee.

**1. Incentive Stock Options**

Incentive stock options and employee stock purchase plans are classified as "statutory options" and as such, qualify for special tax treatment if they meet specific requirements on the date of grant.

If the transfer of stock acquired through exercise of an ISO meets all requirements, no income will be recognized when the option is exercised.<sup>7</sup>

Rules and requirements (among others):

<p><b>Incentive Stock Options Qualifying Disposition Requirements<sup>6</sup></b></p> <ul style="list-style-type: none"> <li>• After the company grants the option, the option and/or the stock must be held at least two years;</li> <li>• After the employee exercises the option, the stock must be held more than one year; and</li> <li>• The employee must satisfy certain employment requirements.</li> </ul>
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- The option price is not less than the fair market value of the stock when granted.<sup>8</sup>
- The option must be exercised within 10 years from the grant date.<sup>9</sup>
- The employee must not own more than 10% of the company's voting shares.<sup>10</sup>
- No more than \$100,000 of stock per year (based on the FMV of the stock at the time of grant) can be exercisable for the first time during any calendar year via an ISO. Any excess is treated as a nonstatutory option (NSO).<sup>11</sup>
- The employee must hold the stock shares for more than one year after exercise.
- The company cannot claim a business deduction either when the option is granted or exercised, unless the employee recognizes ordinary income due to a disqualifying disposition.<sup>12</sup>
- The exercise of an ISO may trigger alternative minimum tax (AMT). The exercise date and the date of any disqualifying disposition will dictate whether AMT rules apply.<sup>13</sup>
- The difference between the regular tax treatment of ISOs and the AMT treatment of ISOs may give rise to an AMT credit that will significantly reduce the tax paid upon the subsequent sale of the business interest by the same person who exercised the options.
- The cost basis in the newly acquired shares (for regular income tax purposes) is the amount paid to acquire the stock, i.e., the option price.<sup>14</sup>
- The option must be transferable only upon the death of the employee and exercisable during the employee's lifetime only by the employee.<sup>15</sup>

- Must be granted within 10 years from the earlier of the date the plan is adopted or when the plan receives shareholder approval.<sup>16</sup>

**Example:**

Chris, age 55, is a participant in an incentive stock option (ISO) plan. More than three years ago, Chris was granted an option to purchase 10,000 shares at \$20 per share (the FMV at the time the option was granted). To satisfy the \$100,000 rule, only half of the shares could be exercised immediately while the other half could not be exercised until the following year.

Today, the stock is trading at \$50 per share. Chris will receive favorable income tax treatment if she exercises her option to purchase any amount of shares. If Chris elects to purchase 7,000 shares, she will pay a strike price of \$140,000 to receive 7,000 shares that are worth \$350,000. The \$210,000 difference between the option price and the current FMV will not be treated as taxable income to Chris at the time the option is exercised. (This difference is treated as a tax preference item for purposes of calculating her AMT.)

After Chris has held the stock shares for at least 12 months and a day, she can sell the stock and be subject to a 15% (federal) capital gain tax on the difference between the sale proceeds and her cost basis. Alternatively, Chris can wait over 12 months (and at least two years from the date the option was granted) before transferring the stock to a DAF and receive the traditional benefits associated with a DAF: income tax savings from an income tax charitable deduction, capital

gain tax savings, estate tax savings and the satisfaction and significance of making a future charitable gift.

The difference between the regular tax treatment of ISOs and the AMT treatment of ISOs may give rise to an AMT credit that will significantly reduce the tax paid upon the subsequent sale of the business interest by the same person who exercised the options.

Because the ability to use the AMT credit becomes limited when the stock that gave rise to the credit is used to make a charitable gift, the suitability of using such stock must be reviewed. For some donors, the loss of the ability to use the AMT credit may be outweighed by their desire to make the charitable gift.

If Chris fails to meet any of the holding period requirements, the ISO status would no longer apply and the option would be treated like a nonstatutory option.

**Tax Tip:** Sell stock if its basis is at or near market value before contributing it to a DAF. A gift of cash is deductible up to 50% of the client’s contribution base (adjusted gross income without regard for net operating losses).  
  
A gift of stock held for long-term is subject to the less favorable 30% limitation.

**2. Nonstatutory Stock Options**

While nonstatutory stock options have many features in common with ISOs, the primary differences are:

- The employee recognizes ordinary income when the options are exercised.
- This income is the difference between the fair market value of the stock at the time of exercise and the exercise price paid.
- Restrictions on transferability are often imposed by the corporation.
- The newly acquired stock has a basis equal to the price paid for the stock when the option is exercised plus the

amount included in income (this is essentially the fair market value of the stock.) Gain or loss is recognized only when the stock is later disposed.

- The employee's holding period for the stock shares starts when the option is exercised; and
- The employer can deduct the amount reported as income by the employee when the options are exercised.<sup>17</sup>
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## ***Practical Considerations***

Although ISOs and NSOs are subject to severe transfer limitations, there are several attractive planning opportunities.

### ***1. Shares of stock acquired through exercising ISOs, which satisfy all holding period requirements are an ideal asset to contribute to a DAF.***

Assuming they have appreciated in value, these shares would generate a capital gain tax if sold outright. The DAF can be effectively used to avoid this tax and provide a perpetual income stream to favored charities.

### ***2. Since exercising ISOs can generate a preference amount for AMT purposes equal to the excess of the stock's FMV over the amount paid for the stock, it is important to coordinate the exercising of these options with other financial affairs.***

Thus, employees owning ISOs often work closely with their tax advisors. Some employees exercise options as early as possible in the 10-year term to avoid losing options after the ten-year expiration date but not so fast that AMT must be paid.

Other employees, time their exercise of options early in the year. The employee will owe AMT unless (s)he disposes of the shares in a disqualifying disposition during the same tax year. If the share price drops

after exercising the option, the employee can dispose of the stock near the end of the tax year. If the disposition occurs during the same tax year as the exercise, then the AMT issue is retained in the same tax year and may be eliminated. On the other hand, the later in the year that the employee exercises the option, the harder it will be for the employee to determine whether to purposefully disqualify the options via an early disposition.

### ***3. Since stock acquired by exercising an NSO has a basis equal to the fair market value of the stock at the time of exercise, it can often be sold without capital gain tax consequences.***

Unfortunately, the ordinary income recognized when the employee exercises the option cannot be avoided. However, making a contribution of stock, perhaps previously acquired and now somewhat appreciated, can generate an income tax charitable deduction that will help to offset some of the tax. One strategy involves making laddered contributions of previously acquired stock designed to correspond to exercise dates. Thus, each time an executive exercises options resulting in a tax liability, a contribution to a DAF is made to generate a charitable deduction to help offset the tax. This strategy can be employed over a period of years. Each year, the executive can coordinate the number of options exercised with the size of the contribution to the DAF.

## ***For More Information***

- Planned Giving Design Center's Technical Reports available at [www.pgdc.com](http://www.pgdc.com)
- Madden, Robert, Tax Planning for Highly Compensated Individuals, 2012, Thompson/RIA
- [www.MyStockOptions.com](http://www.MyStockOptions.com)

- Tax Facts on Investments, Questions 7536 - 7541, The National Underwriter Company
- Miree, Kathryn, Professional Advisors' Guide to Planned Giving, Aspen
- Internal Revenue Code §§83, 162, 421-424 & their accompanying Treasury Regulations
- Revenue Ruling 98-21
- Private Letter Ruling 9308021 (cannot be cited as precedent)

## Endnotes

1. IRC §422(b)(5)
2. IRC §422(a)(1)

3. IRC §422(a)(1)
4. IRC §422(a)(2)
5. IRC §83
6. IRC §422(a)
7. IRC §421(a)(1)
8. IRC §422(b)(4)
9. IRC §422(b)(3)
10. IRC §422(b)(6). But see IRC §422(c)5 for an exception.
11. IRC §422(d); Treas. Reg. §1.422-4
12. IRC §421(a)(2)
13. IRC §§56(b)(3) and 83
14. IRC §421(c)(3)
15. IRC §422(b)(5)
16. IRC §422(b)(2)
17. Treas. Reg. §§1.83-6 & 1.162-7

With over 7,000 wealth management instruments under administration including Donor-Advised Funds, Renaissance is the nation's largest and oldest third-party administrator of charitable gifts. Renaissance provides third-party administration to all types of trusts and regularly provides advanced training to financial planners, attorneys, CPAs, trust officers and planned giving officers.

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