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Surf's Up, Dude! High Tech Tax Solutions for High Tech Workers!

Tax Planning Solutions for the Exercise of Incentive Stock Options

I remember the first time that I signed onto the internet. It was 1998 and I had just started work for Deloitte and Touche in Boston. My boss was traveling on my first day with the company, so I had to entertain myself “surfing” the web. I wasn’t quite certain what would happen. During this same time period, the “Tech Boom,” I used to take the train daily from South Attleboro to South Station. As I used to walk through South Station, tech companies used to have recruiting tables set up to speak with passengers passing through the terminal. The thinking was that “brick and mortar” companies would become dinosaurs. The bubble burst and “brick and mortar” companies survived. A lot of people made a lot of money as an early employee in a tech company. My roommate was one of those guys. Admittedly, he was smarter, but I was better looking (at least in my own mind!). That was then and this is now!

My feeling about tech after the pandemic is that it has “wheels” meaning it has great relevance and opportunity following the Corona Virus pandemic. It seems like technology provides an answer to many business problems. Silicon Valley has utilized stock options – qualified and non-qualified stock options have a compensation incentive for technology workers. This article focuses on the planning opportunities to mitigate the taxation associated with the exercise of Incentive Stock Options (“ISO”).

Overview of Incentive Stock Options

An employer’s structuring of an employee’s compensation in the form of options to purchase stock in the employer, instead of cash, allows an employer to provide a direct incentive to the employee, to enhance stockholder value, and conserve available cash to use in the growth of the corporation. An option granted under a compensatory stock option plan provides the employee receiving the option, the opportunity to share in the appreciation in the value of the employer’s stock before the option is exercised without assuming the risk of a decline in value of the stock.

An employee in a high-tech company has no tax consequences when he receives a grant of ISOs regardless of vesting. Furthermore, the employee has no tax consequences upon the exercise of the option. However, the amount by which the fair market value of the stock received upon the exercise exceeds the exercise price is generally a tax preference adjustment for purposes of the alternative minimum tax (AMT) calculation. Any AMT paid may be taken as a credit in future years when the AMT may be applicable.

Because an employee does not recognize taxable income on account of the grant of an ISO and generally does not pay the exercise price or any other consideration for an ISO until exercise, the employee's basis in an ISO will generally be zero. The tax basis that the employee acquires in the ISO stock will be the amount the employee paid upon exercise of the ISO.

When an employee incurs a gain on the sale of the stock, the character of the gain depends upon both the length of time from the grant of the ISO to the date of sale and the length of time from the exercise of the ISO until the date of sale. Losses are generally capital losses, with the holding period generally commencing the day after the date of exercise.

The tax treatment of the disposition of company stock acquired through the exercise of an ISO depends upon whether the stock is disposed of before the end of the holding period. The holding period ends on the date that is the later of: (a) two years from the date of the ISO grant; or (b) one year from the date on which the ISO stock was transferred to the employee upon ISO exercise.

When an employee disposes of ISO stock after completion of the statutory holding period (i.e., after the stock has been held more than two years after the date the option was granted and more than one year after the date the option was exercised), the employee will be required to recognize the difference between the amount received in such disposition over the employee's basis in the ISO stock as capital gain income.

An ISO, by its terms, cannot be transferable except upon the death of an employee and a few other exceptions such as a divorce property settlement. Although the non-transferability rule is seemingly absolute on its face, the IRS has permitted transfers of ISOs to certain trusts treated as grantor trusts of the employee and, therefore, generally disregarded for income tax purposes. It is unclear whether a transfer to a single member LLC would fall within the same exception. My person feeling is that such a transfer would not violate the non-transferability rule.

If an employee disposes of ISO stock before the statutory holding period expires, the disposition will be considered a "disqualifying disposition." A disqualifying disposition generally requires the employee to recognize as ordinary income, in the tax year during which the disqualifying disposition occurs, the difference between the ISO's exercise price and the ISO stock's fair market value at the time of option exercise (the "bargain purchase element").

Planning Considerations

Facts

Bob Smith, age 40, and married with two children. He is a resident of California. He works in customer service for ChickFlix, an online streaming service, focused on programming for women. His salary is \$150,000.

The company granted Bob 3,000 options at \$2 per share three years ago. He exercised the option over a year ago. The company is now being sold at a price of \$250,000 per shares in the fall of 2020 to a large online provider. The shares will be sold at a long-

term capital gains rate for federal and state tax purposes. He combined marginal tax bracket for capital gains purposes will be 37.1 percent.

Strategy 1 The Zuckerberg Charitable LLC

Bob creates a new limited liability company (LLC) as the management vehicle for his philanthropic initiatives similar to Jeff Zuckerberg who contributed \$45 billion to the Chan Zuckerberg Initiative, LLC. Bob contributes the proceeds (\$850,000) from the sale of the ChickFlix shares to the LLC in exchange for a combination of common and preferred LLC units. The preferred units (Class B) will provide a return equal to the par value of the Class B units. The Class A units will enjoy the investment return in excess of the Class B return. Bob is the managing member of the LLC.

Bob creates a donor advised fund with Acme Charity, a 501(c)(3) organization. Bob contributes the class B units to Acme for the benefit of his donor advised fund. The appraised value for charitable gift purposes of the Class B units after discounting for lack of marketability and control is \$680,000.

The donation of the Class B units will be treated as a gift of short-term capital gain property with a deduction threshold of 50 percent of adjusted gross income (AGI). Bob's AGI in 2020 is \$1,025,000. He may use \$512,500 of the deduction in 2020 and carry forward the excess deduction of \$167,500 in 2021. This deduction will substantially shelter the gain associated with the exercise and sale of the underlying shares.

As manager, Bob is able to retain management and control over the investments of the LLC. As manager, he is able to control the amount and timing of charitable distributions. He intends to distribute 2-5 percent of the LLC asset based each year to his donor advised fund. Bob will also as manager reserve the right to pay himself a management fee. He may also provide a loan to himself as manager on an arms-length basis. The current interest rate for long term loans (more than nine years) based on the applicable federal rate is 1.15 percent. The loan proceeds are tax-free.

Strategy 2 "Surf's Up" Pooled Income Fund

Assuming the same facts from above, Bob contributes \$875,000, the amount of the sales proceeds, to a new Pooled Income Fund (PIF), established by Acme Charity. The PIF provides that Acme will provide an income from the PIF of Bob and his wife. Furthermore, the PIF allows Bob's investment advisor to manage the funds within the fund. The structure provides Bob with a charitable deduction equal to 57 percent of the contribution which is \$390,000. Based on the level of AGI in 2020. The entire amount of the tax deduction may be used in 2020. The investment structure within the PIF so that excess investment return above a 3 percent return accrues for Bob and his wife personally. At the death of Bob and his wife, the funds will pass to his donor advised fund to support his charitable purposes.

Summary

The ability to prosper through the intelligence, entrepreneurship and risk taking of technology innovators and entrepreneurs is exciting but it is not what you make but

what you keep that counts. This short article outlines two strategies to consider when faced with the tax consequences of ISOs. The LLC strategy has a great progenitor, Mark Zuckerberg. The second strategy is a lesser known strategy but powerful.

Where do I come in? The stock market will come roaring back in the future and initial public offerings and M&A activity will regain its stride. These strategies will help you keep more of the deal in your pocket. If you would like to understand the market opportunity or discuss a case, I can be reached at:

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