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Hedging Your Employee Stock Options (Part 3) mso+

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In Part 1 of this article series I wrote about the tax issues of NQSO hedging and mentioned potential securities law constraints on your ability to hedge that apply to company stock and options. A rule change in 2009 by the Securities and Exchange Commission now lets unexercised employee options act as collateral for listed publicly traded options. (The SEC will allow this structure only if the employee options are vested.) Until now, if the holder of employee options sold exchange-traded calls on the underlying stock, those call options were considered to be written naked. These naked calls would need a lot of collateral as margin, and if the stock price were to increase, they would require even more margin. If the options are considered to be covered-call options, as the recent ruling states, then only the unexercised options are necessary as collateral.

The rule change potentially makes it possible to sell covered calls in the market and lock in some of the unrealized gains in unexercised employee options. You can now more easily capture the income available through the sale of call options. The time premium associated with options is normally not available to you and is automatically lost upon exercise of the employee options. While the path for capturing this time value is still not entirely clear, a major SEC hurdle related to the use of employee stock options as collateral for selling call options has been surmounted, thanks to the persistence of Joe Klein and Colleen Sullivan of iOptions.

The SEC's rule change potentially makes it possible to sell covered calls in the market and lock in some of the unrealized gains in unexercised employee stock options.

> **Example:** Jennifer's employer grants her options to purchase 1,000 shares of its stock at the current market price of $50 per share. The options are vested. Jennifer sells listed equity call options to purchase the stock at $60 per share and receives a premium of $1 for the sale of the options from her broker.

Two Potential Stumbling Blocks

You will not be able to immediately take advantage of the new ease in selling calls on your vested employee stock options.

Company Must Agree

First, given the uncertificated nature of employee stock options, you will need the assistance of your employer to complete transactions under the SEC rules. Before the unexercised employee options can act as collateral, your company must sign an agreement that contracts it to deliver shares (if you exercise the option) only to the broker-dealer, not to you. This agreement will also stop the unexercised options from being pledged more than once. Your employer must also agree to waive any forfeiture conditions that otherwise might apply to the employee options, such as forfeiture on termination of employment, as well as any transfer restrictions that would preclude pledging of the employee options. In addition, your company will represent that the employee options are covered by an effective registration statement on Form S-8, which is almost universally done for public company stock plans. If the registration statement becomes ineffective, your company agrees that it will notify the broker-dealer immediately. Until this process becomes standard operating procedure, many employers are likely to balk at these obligations.

In addition, separate from these mechanical requirements, companies may not like the concept of employees selling call options on their stock or the need to remove forfeiture provisions. Hedging employee stock options adds another layer of complexity to a form of compensation that already confuses many employees. While this can be perceived as adding value to the compensation, it also exposes employees to the risk of needing to deliver on the call, or to the tax problems discussed below. Even in a rising market, that risk can defeat the motivational incentive behind the option grant: i.e., employees would not want their company's stock price to climb above the strike price of the call. Employees would also tend to hold their options longer (i.e. wait to exercise) if they could sell calls, and this would increase the company's accounting charge for the grant.

Stumbling Block With Taxation

The value (i.e. the spread) in nonqualified stock options gives rise to ordinary income at exercise. The potential problem is a whipsaw if the price of the underlying company shares increases after the call options are sold. As the stock price increases, more ordinary income will be generated upon exercise of the employee options to obtain the shares needed to deliver on the call option. The economic tradeoff is a corresponding loss in the listed call options: a capital loss. The combination of large amounts of capital losses and a like amount of taxable ordinary income can

be costly for those without capital gains to net against the losses.

> **Example:** Continuing the prior example, the price of the underlying stock that Jennifer owns rises to $62, and the holders of the listed options exercise them to acquire the stock. Jennifer needs to deliver the shares within two days and does not want to use cash or purchase additional company stock to close out the option position. Jennifer exercises her employee options and receives $12 of compensation income for each employee stock option ($62 stock price minus $50 exercise price).
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> The tax treatment of these transactions is not entirely clear but it seems to us the most probable treatment is as follows. Ignoring commissions, the net amount Jennifer receives on the exercise of the options she has written is $61 per share ($60 share price plus $1 option premium). Her basis in the stock is $62 ($50 paid to exercise her options on the stock plus $12 ordinary income recognition, which increases the stock basis). She therefore has a capital loss of $1. This will be short-term because of the brief holding period of the underlying stock.

In Part 2 we wrote about an individual's possible use of Internal Revenue Code Section 1221. This provision was enacted so that corporations hedging business risks in the normal course of their business aren't saddled with capital losses when a business hedge goes against them. The question is whether an individual can make a 1221 election when placing a hedge.

Some comfort has been taken from an IRS private-letter ruling that provided guidance about the application of Section 1221 when a derivative is used to hedge in the context of employee compensation. This ruling involved an employer that offered employees deferred compensation based on the performance of certain mutual funds. The employer identified the corresponding investment as hedging transactions under Section 1221. The ruling held that the deferred-compensation obligation was an "ordinary obligation" and that the investment contracts qualified as hedging transactions for purposes of Section 1221.

The ruling also stated that the employer's deferred-compensation liability is an "ordinary obligation" under Section 1221. Although employee options are an asset, not a liability, in the hands of an employee, the same analysis could arguably apply. It is rumored that one of the banks requested a private ruling on this question but withdrew the request on learning that its request was likely to be denied. The problem may be that there is considerable doubt as to whether an employee can satisfy the "normal course of the taxpayer's trade or business" requirement of Section 1221(b)(2).

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