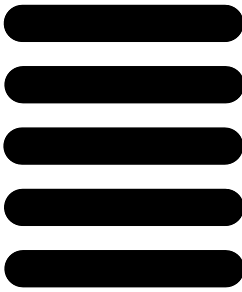

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Options: From Basics to Backdating

By Robert W. Wood • Wood & Porter • San Francisco

Much of the fretting over stock option backdating may have passed from our scene, leaving our collective consciousness once it left newspaper front pages. Still, the fat lady has hardly sung. Broadcom has just settled its case with the SEC for a whopping $12 million. [*See* Burns and Scannell, *Broadcom, SEC Settle Backdating Case,* WALL ST. J., Apr. 23, 2008, at B3.]

This "penalty" (if that's how Broadcom ends up treating it for accounting and tax purposes!) still seems a drop in the bucket when one considers Broadcom's restatement of its financial results and its report of more than $2 billion in additional compensation expenses. Broadcom may have some choices on these issues since its settlement with the SEC (predictably) did not admit liability.

Mercury Interactive (now owned by HP) hosted the biggest backdating bonanza, with a $28 million payment to the SEC and a $117.5 million payment to settle a class action. Yet, brand-new backdating charges are still being made, and some are explicitly tax-related. A former Mercury Interactive CFO was just charged with tax evasion. [*See* Chang, *New Backdating Charge,* FINANCIAL TIMES, Apr. 23, 2008, at 18.]

Pixar's former CFO was also targeted for an SEC civil action. [*See* Wingfield, *SEC Targets Ex-Finance Chief of Pixar,* WALL ST. J., Apr. 29, 2008, at C3.] Marvell Technology and one of its founders also settled with the SEC. The company paid a $10 million fine, and Weili Dai, a former officer and director, agreed to pay a $500,000 fine. [*See* Scheck, *Marvell Settles Backdating Case,* WALL ST. J., May 9, 2008, at B7.] Moreover, the SEC has now filed civil charges against Henry Nicholas III, Broadcom's former CEO, and Henry Samueli, its current chairman and chief technology officer. Also named were David Dull, the company's general counsel, and William J. Ruehle, its former CFO. [*See* Clark and Scheck, *SEC Charges Broadcom Founders in Options Case,* WALL ST. J., May 15, 2008, at B1.]

In all this hubbub, the effect on the options themselves often goes unmentioned.

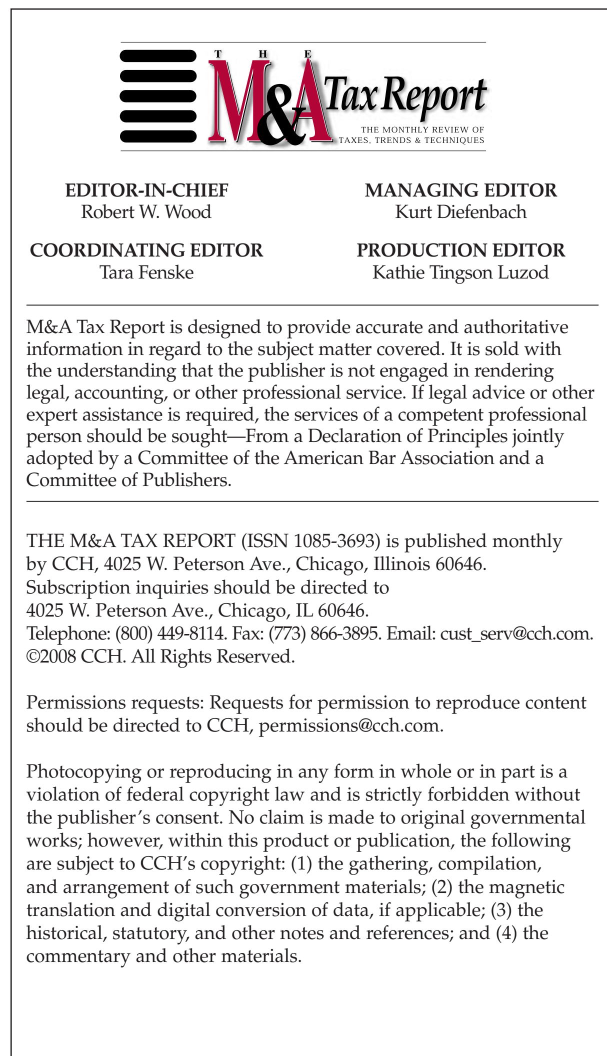
ALSO IN THIS ISSUE

How Personal Is Goodwill? 5
A Helpful Tax Reference Book 7

Option Basics

Options give employees the right to buy shares at a specified price. If the stock price rises, the employee will presumably exercise the option, and thus will get a bargain purchase. That will eventually lead to gains when the employee sells the stock. One must distinguish between nonqualified options and incentive stock options ("ISOs") because they are subject to two very different tax regimes.

ISOs are subject to various restrictions. Notably, the option price must at least equal the fair market value of the stock on the date of the grant. [*See* Code Sec. 422(b)(4); Reg. §1.422-2(a)(2)(iv).] This requirement prevents "in the money" options, where the option price is less than the value of the stock on the date the option is granted. There is also an overall limit of $100,000 on the incentive stock options that can be awarded per recipient each year. [*See* Code Sec. 422(d); Reg. §1.422-4(a).]



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With nonqualified options, there is infinite flexibility. The option price can be set at any level. Employers often provide vesting over many years. The greater flexibility of nonqualified options comes with a price, though, for ISOs are taxed more favorably. With nonqualified options, there is no tax when the option is granted, as long as the option has no readily ascertainable market value. [*See* Code Sec. 83(e)(3) and (4).] Any appreciation from the grant date to the exercise date is taxed as ordinary income at the time of exercise.

With incentive stock options, there is no (regular) tax to the participant when the option is granted or when it is exercised. [*See* Code Sec. 421(a)(1).] The employee pays tax only when the shares (acquired when the ISO is exercised) are actually sold. Any appreciation from the date of grant to the date the shares are sold will be taxed at capital gains rates provided certain rules are met. [*See* Code Sec. 422(a)(1); Reg. §1.422-1(a)(1)(i)(A).] Incentive options are therefore generally better from a tax viewpoint.

AMT Trap

However, there is a big exception to this favorable tax treatment because of the alternative minimum tax (AMT). When an employee exercises ISOs, even though there is no *regular* tax due on the exercise (as noted above, tax normally applies only when the shares are actually sold), there can be AMT. [*See* Code Sec. 56(6)(3).] On exercise, the excess of the fair market value of the options over their exercise price is considered preference income subject to AMT. [*See* Code Sec. 56(6)(3).] Whether preference income is taxable depends on a variety of factors, including the taxpayer's other income.

> **Example.** Emily Employee receives a grant of ISOs allowing her to buy 1,000 shares of Tech, Inc for $10 per share. The stock goes up to $20, and Emily exercises, purchasing 1,000 shares. Because these are ISOs, she pays no regular tax until she sells the shares. However, the $10,000 difference between the exercise price and what she paid for the shares represents preference income. Whether Emily will have to pay the 28-percent AMT tax on this income will depend on her other income, other AMT items, the use of her AMT exemption, *etc.*

The AMT issue for incentive stock options can arise in the year of exercise, even if the shares later become worthless. Many employees have found this out the hard way.

409A Surtax

Much of the worry over option backdating problems comes from Code Sec. 409A, a provision that you might think (on first glance) would be irrelevant to stock options. Code Sec. 409A impacts not only stock options, but any kind of deferred compensation. A relative newcomer to the Code, Code Sec. 409A was added by the American Jobs Creation Act of 2004 (P.L. 108-357).

In general, Code Sec. 409A provides that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan are currently includable in gross income, and the amount includable in gross income is subject to certain additional taxes. [*See* Code Sec. 409A(a)(1)(A).] Code Sec. 409A applies to certain discounted stock rights, occurring, for example, when stock options are issued with an exercise price less than the fair market value of the stock on the grant date. When the option is exercised, it is treated as an impermissible payment of nonqualified deferred compensation under Code Sec. 409A.

Triggering the 409A rules means that not only is the normal stock option amount taxed, but an additional 20-percent income tax is also levied. [*See* Code Sec. 409A(a)(1)(B).] Plus, there is a second additional tax equal to the amount of interest on unpaid taxes from the year of the initial deferral (calculated at the underpayment rate plus one percent). This latter tax is often referred to as the "interest tax."

Surtax Trigger

Option plan participants need to understand the difference between nonqualified options and ISOs, and the difference between regular tax and alternative minimum tax. Moreover, they also need to worry about the additional 20-percent tax imposed by Code Sec. 409A. Code Sec. 409A and its new taxes ought not to touch most stock options. But unfortunately, it is now clear that the complicated rules of Code Sec. 409A do apply to options backdating problems. [*See* Poerio, *Tax Urgency for Backdated (or Misdated) Stock Options: 409A Penalties Absent Action in 2006,* 33 BNA Pensions & Benefits Rep. 2487 (Oct. 17, 2006).]

Under Code Sec. 409A and the IRS's explanatory rules adopted thereunder, improperly priced options can trigger the 20-percent surtax, on top of the already steep ordinary income tax rates. Thus, one can pay ordinary income tax plus a 20-percent surtax (plus interest). These special taxes apply in the year an executive is first allowed to exercise options (thus, when the options "vest"), even if the executive exercises them later. Note that taxes are due if the options vest, even if the options later lose value before exercise, or even if they remain unexercised.

Paradoxically, the 409A rules regarding deferred compensation may have indirectly provided relief for some options backdating problems.

Paradoxically, the 409A rules regarding deferred compensation may have indirectly provided relief for some options backdating problems. Code Sec. 409A was designed to curtail what Congress thought were inappropriate tax deferrals, including the practice of granting options to employees at less than the fair market value of the stock. Under Code Sec. 409A, such options are treated as nonqualified deferred compensation, triggering negative tax consequences.

Backdating and Taxes

It is difficult to define what we mean by "backdating." In part, this is due to the fact that there have been significant variations in fact patterns. Much of the debate about this subject centers on which practices are legitimate and which are not. Most of us realize that a company should not issue options to an employee on March 1, 2008, and state that the issue date was actually March 1, 2007.

But, many fact patterns involve closer calls. For example, suppose a company hires a new employee on June 1, scheduling the worker to start full-time on July 1, but offering to issue

options to the employee on June 1 based on a "part-time" work schedule during the interim.

Is that backdating? What if the part-time work is really more fiction than fact? Is it a question of degree?

To take another interesting case, suppose that a company's board or compensation committee (as appropriate) takes all necessary action to grant options, but the resolutions aren't fully signed by all necessary parties for two weeks. Is it backdating if the grant is signed by a straggler signatory two weeks after the "grant"?

Does it depend on whether the signature merely confirms a prior telephonic meeting? Counsel will need to advise option holders and stockholders about their potential liabilities, including tax liabilities.

Exercise Dates

Although most of the focus of the stock options backdating controversy has surrounded *grants* of options, the taint has spread to *exercise* dates as well. In fact, an SEC paper suggests that some executives have manipulated the exercise dates of their options. [*See* Maremont & Forelle, *How Backdating Helped Executives Cut Their Taxes*, WALL ST. J., Dec. 12, 2006, at A1.] The reason seems purely tax motivated.

Often denominated as the "strike price," the exercise price is usually the stock's market price on the day the options were granted. When an employee exercises an option and acquires actual shares, the employee often immediately sells the shares. This is extremely common with nonqualified options.

The employee in this situation would pay ordinary income tax on the spread between the strike price and the sale price. Plus, the exercising employee may owe payroll taxes. Sometimes, though, the executive who exercises the options does not sell the stock immediately. Again it is important to differentiate between ISOs and nonqualified options.

Suppose an employee holds nonqualified options. If the employee exercises the options and then holds on to the shares for at least a year after the exercise, the employee may pay a far lower tax (capital gains tax rates are only 15 percent, compared to ordinary income rates of 35 percent). The fact that the employee will pay tax at only the 15-percent rate if the employee holds onto the stock for more than a year means serious money is at stake.

Example. Eric Executive holds nonqualified options on 100,000 shares with a strike price of $10. If Eric exercises and sells the stock immediately when the price is $20 a share, Eric will realize $1 million in income and must pay ordinary income tax on his gain. At a flat 35 percent, Eric must pay $350,000 in federal tax.

Yet, if Eric can claim that the stock was worth $16 at the time the option was exercised at the $10 strike price, Eric's $350,000 tax bill on exercise goes down to $210,000. Plus, if Eric sells a year later when the stock is at the same price of $20, Eric will pay only $60,000 in capital gains tax. That means his total tax is $270,000, not $350,000. [*See* Maremont & Forelle, *supra.*]

Of course, in both situations, Eric has the same $1 million gain, but he has saved $80,000 in taxes. A key element, of course, is what the strike price truly is (in this example, the price on the date the options were issued).

Of potentially even greater importance is the stock price on the date of exercise. And, thus, allegations of backdating of exercise dates may become the newest gambit in the stock options backdating scandal.

Payroll Tax Liabilities

In addition to the impact on employees and their own tax problems occasioned by options dating controversies, companies have their own set of tax issues. Companies are subject to penalties for failing to withhold on compensation. [*See* Code Secs. 3101 *et seq.* (FICA), 3301 *et seq.* (FUTA); *see* Rev. Rul. 67-257, 1967-2 CB 359.] Many stock options are compensatory, and payments to employees can constitute wages. The additional taxes, penalties and interest that may be issued against companies can be substantial.

Furthermore, the stock option area has unique rules. For example, companies must generally collect payroll taxes if incentive stock options do not meet certain conditions. Backdated ISOs would violate the fundamental rule that the options price must be no less than the fair market value of the stock on the date of issuance. Thus, they would have to be treated as compensation and the employer would be responsible for tax withholding. [*See* Rev. Rul. 79-305, 1979-2 CB 350.] Not only that, but tax would probably be due on the

value of the options when they are exercised, not the value when they vest.

Some companies have to pay these additional taxes, and that can mean not only their share, but also their employee's share of these additional taxes. The company may then try to collect the employee portion of these payroll taxes from its current or former employees.

IRS Settlement Program

The IRS devised a plan to help rank and file employees who owe taxes because they unwittingly received backdated stock options. Employees who received backdated options must pay the additional 20-percent tax, plus an interest element. Yet, the IRS program requires the *employer* to bear the entire tax burden of the backdating.

Announced in early February 2007, the IRS gave companies only until February 28, 2007, to notify the IRS of an intention to participate in this program, and only until March 15, 2007, to actually contact employees. With this deal now over, it is unclear if there will be a second chance at this program. The IRS proposed that companies with backdating problems pay the steep additional taxes due from lower level employees who exercised backdated options in 2006.

Applying only to options that vested in 2005 and 2006 and that were exercised in 2006, few companies took advantage of this program. Companies were not allowed to resolve any of their top executives' taxes this way. Still, some companies have taken steps to spare top executives from tax on options they haven't yet exercised by repricing the options to fix any backdating problems. In some cases, companies have even paid executives a special bonus to compensate them for the repricing.

State Tax Compliance, *etc.*

In addition to considering the federal income tax effects of backdated stock options, companies (as well as employees) must consider state income tax rules. Many states (like California) conform to Code Sec. 409A. Nevertheless, it is not clear what many states will do with backdating.

Then there is the add-on problem. When companies pay additional state or federal taxes, such payments of tax on behalf of employees probably will usually generate additional taxable income to the employees. This circular "tax on a tax" problem is likely to catch employees unaware.

Conclusion

The primary thrust of stock options backdating concerns surely lies outside the tax realm. Nevertheless, tax considerations play a part. That's true for companies struggling through these unfortunate circumstances, and for the employees (and former employees) who actually receive the options.

Backdating issues were recently demoted from a Tier I to a Tier II issue. [*See* LMSB-04-0308-017 (Apr. 22, 2008).] Surely that demotion reflects reduced angst about the extent to which the IRS finds stock option backdating to be a burning issue.

Still, we'll likely see more fallout from backdating before we're completely out of the woods.