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Occupy Their Options

By Christopher A. Karachale • Wood LLP • San Francisco

Stock options are a perennial source of debate, confusion and even envy. In the pages of THE M&A TAX REPORT, we have often examined the sometimes opaque rules that govern them. These hallowed principles dictate the time and character of income arising from the receipt of nonqualified stock options. [*See, e.g.*, Christopher A. Karachale, *Options in the Web 2.0 Bubble*, M&A TAX REP., June 2011, at 1.]

However, the flip side of the coin is the ordinary and necessary business expense deduction to the corporate option grantors. It is no less significant, and even its seemingly straightforward application can give rise to controversy. Internal Revenue Section ("Code Sec.") 83(h) provides the basic scripture: Where a nonqualified stock option is granted in connection with the performance of services, a deduction under Code Sec. 162 is allowed to the corporate transferor. The deduction is equal to the amount the grantee takes into gross income. The deduction accrues in the tax year in which the income from the grant is included in the gross income of the person who performed the services.

The deduction to the option-grantor adheres to general income tax principles. The Code Sec. 83(h) rules are predicated on the fundamental consistency that underlies the tax treatment of entity-level business expenses. Namely, in an effort to ensure that only net costs are taxed to a corporate entity, a deduction is allowed to the corporate payor equal to the income that accrues to the payee.

As Justice Hugo Black stated in *M.F. McDonald*, SCt, 44-2 USTC ¶9516, 323 US 57, 66–67 (1944): "Taxation on net, not on gross, income has always been the broad basic policy of our income tax laws. Net income may be defined as what remains out of gross income after subtracting the ordinary and necessary expenses incurred in efforts to obtain or to keep it." Under Code Sec. 83, the timing of the income and deduction from option grants is predicated on this symmetry.

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Man the Equity Barricades

Perhaps inspired by the Occupy Wall Street movement, congressional policymakers have focused their sights on Code Sec. 83(h). In mid-2011, Senators Carl Levin (D-Mich.) and Sherrod Brown (D-Ohio) introduced legislation entitled "Ending Excessive Corporate Deductions for Stock Options Act," S. 1375. The supposed purpose of this bill is "to end a corporate tax break allowing corporations to deduct stock option expenses on their tax returns in amounts greater than the expenses shown on their books, thereby making the tax code more fair and cutting the budget deficit by $25 billion over 10 years."

The proposed legislation would add a new subsection to Code Sec. 162. It would provide that the business deduction to the corporate option grantor cannot exceed the amount the taxpayer has treated as compensation cost for purposes of the corporation's financial books. Moreover, the deduction could only be taken into account in the same period that such compensation cost is recognized for book purposes.

According to Senator Levin, the Ending Excessive Corporate Deductions for Stock Options Act is intended to make the financial statements and tax returns of corporations consistent. Currently, FASB Statement No. 123 requires corporations to report stock option expenses on their financial statements using the value of the options *on the date they are granted*. In contrast, in the appropriate circumstances, Code Sec. 83(h) allows corporations to deduct the stock option expense when the stock options *are exercised* (*i.e.*, the year in which the service provider also recognizes the income).

Of course, in the year of exercise, the stock has often appreciated so the option holder obtains a significant benefit when he exercises. Barring a Code Sec. 83(b) election, the option holder will recognize (as ordinary income) the difference between the fair market value of the stock at the time of exercise and the grant price of the option (less any amounts originally paid for the option). The appreciation in stock value may also be advantageous to the corporation.

After all, the option-granting corporation could receive a much larger ordinary and necessary business deduction at the time the option is *exercised* rather than at the time the option is *granted*. The increased value of the stock inures to the company's benefit in the form of a larger deduction.

This appreciation of the potential business deduction appears to be the target of the Ending Excessive Corporate Deductions for Stock Options Act. The corporation's tax deduction must match its financial statements under FASB Statement No. 123. Thus, the tax deduction could only occur in the year of grant, when the price of the grant is often *de minimis*.

As a consequence, the corporation would not be privy to the potential stock appreciation that typically makes option grants so appealing to workers. Senators Levin and Brown believe that a corporation's financial statements and tax returns should be consistent. However, the means to implement this consistency has the potential effect of severely limiting the business deduction previously allowed to corporations.

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EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Farley

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Options for a Revolution

The media has not let the deduction for stock options go unnoticed. David Kocieniewski of the NEW YORK TIMES reported that options granted in the "dark days" of 2009 have created a potential windfall for hundreds of executives. [*See Tax Benefits From Options As Windfall for Business*, N.Y. TIMES, Dec. 30, 2011, at A-1.] One wonders if they are part of the now-decried one percent. According to Kocieniewski, the corporations that gave those generous awards include Sirius XM, General Electric, Starbucks and Goldman Sacks. More interestingly, Kocieniewski claims these companies "are beginning to benefit, too, in the form of tax savings." Kocieniewski's point is that the corporations will receive large deductions under Code Sec. 83(h) relative to the depressed value of the stock at the time of the option grants.

As the corporate executives exercise their options, the corporations will be the indirect beneficiaries of the market appreciation since 2009. Here at THE M&A TAX REPORT, of course, we leave policy debates and decisions to members of Congress and the media. However, it is hard to ignore the fact that the Ending Excessive Corporate Deductions for Stock Options Act has a rather populist bent.

Whether or not such legislation is aimed at the one percent and the corporations that employ them, the current nonqualified stock option regime is based on a defensible symmetry. It conforms to the larger tax landscape of business income and expenses. If Senators Levin and Brown wish to impose limitations on the deductibility of equity compensation, there may be good—and even outstanding—justifications for legislation.

However, to assert that the Ending Excessive Corporate Deductions for Stock Options Act is intended simply to make financial reporting and tax reporting standards "consistent" seems disingenuous. If the goal of the legislation is to increase the fisc at the expense of the one-percent corporate hegemons, it would be refreshingly transparent to simply say so.

Case in Point for Option Deductions

A recent Tax Court memorandum opinion shows the significance—and potential benefits—of Code Sec. 83(h). In *A.L. Davis*, 102 TCM 575, Dec. 58,831, TC Memo. 2011-286, the Tax Court was forced to untangle a "whipsaw" problem related to the exercise of stock options. Interestingly, the parties who had the most to gain (or lose) from the treatment of the options were warring members of a family that conducted a business through an S corporation.

The corporation in question was CNG Financial ("CNG"), operating a "payday" loan business. CNG was rather successful in the short-term loan business. It was founded in 1994, and by the end of 2002, had expanded to 834 stores with revenues of $199 million. By the end of June 2003, CNG had exploded to 1,106 stores and revenues of $273 million.

Like many S corporations, CNG was operated by a family and was thus ripe for tax and familial discord. Like a payday loan, it seemed almost certain. Jared Davis had founded CNG with a loan from his father, Allen. Jared's brother David and his sister Laura worked for the company and owned shares.

To facilitate its rapid expansion, CNG received large infusions of cash through Allen's assistance and connections with banks and other financial institutions. Allen received shares of the company and participated in the day-to-day management of CNG. The CNG shares were not traded on an established securities market.

Then came significant family strife. Allen attempted to remove David from the CNG board. Allen's wife (Jared, David and Laura's mother) made a demand during their divorce for half of Allen's CNG shares. Jared filed a complaint in Ohio state court seeking declaratory judgment that Allen had to sell Jared his shares.

After all of this episodic drama, though, the Davis family came to a tentative resolution. Allen was granted options to purchase shares of CNG stock in 2002 through a cashless exercise provision after he transferred certain shares to his ex-wife. Allen's grant was contingent on his continued assistance to CNG.

This seemed simple. Allen exercised the options in 2004 and received 131 shares of CNG. CNG treated the shares as a $36,962,694 compensation deduction. It flowed through to the individual returns of the corporate shareholders including Jared and David.

However, in an apparent attempt to add to the family fiasco, Allen did not treat the exercise as taxable and did not include the stock value in his gross income for 2004.

Not Many Options

Allen asserted a variety of arguments for the novel proposition that his option exercise was not governed by Code Sec. 83. Of course, if Allen's exercise of the options did not produce income to him in 2004, then CNG would not be allowed the compensation deduction under Code Sec. 83(h). Thus, this family squabble pitted Allen not only against the IRS, but also his children and the other CNG shareholders.

The Tax Court quickly dismissed Allen's arguments that Code Sec. 83 did not control. First, it was clear that the options were transferred in connection with the performance of services. CNG had granted Allen the options to purchase the shares to induce him to continue assisting the company as it rapidly expanded.

That the option grant was intended to secure Allen's participation in the company was enough to bring it within the ambit of Code Sec. 83. Allen then contended that even if the option grant were governed by Code Sec. 83, the cashless exercise provision effectively reduced the options' exercise price, limiting the gross income to Allen. The Tax Court similarly batted this argument away and concluded that Allen did have gross income of $36,962,694 in 2004, the year of exercise.

Compensation Deductions in Action

The Tax Court then moved on to the tax implications of the option exercise for CNG. The give-and-take of Code Sec. 83 provides that where property is transferred in connection with the performance of services, the employer may deduct the amount included in the employee's income. Here, the IRS was forced to take a different tack. While conceding Code Sec. 83(h) might apply, the IRS asserted that Allen's compensation was *unreasonable*. Therefore, it was barred by the general requirements of Code Sec. 162(a). The Tax Court, however, was unmoved.

According to the Tax Court, the key was that Allen's options were contingent compensation. Inherent in the options and the underlying stock was Allen's right to receive the appreciation in the value of the shares at the time of the cashless exercise. It was not unreasonable that the amount Allen received from the exercise turned out to be greater than what would have ordinarily been the appropriate compensation.

In addition, although Allen, Jared and David were all members of the same family, there was no family taint. The Tax Court concluded that the option grant was the result of arm's-length bargaining. In the Tax Court's view, they were all "looking out for their own interests."

Indeed, Jared had filed a complaint in state court seeking to force Allen to sell his shares. David openly distrusted Allen. Allen had even threated to leave CNG when CNG needed him to obtain financing.

These adverse interests meant that the option grant should pass muster under the Code Sec. 162 reasonable compensation test. More importantly, the contingent nature of the option grant was significant. It meant that both Allen and CNG should reap the benefit of the income and compensation deduction arising from the exercise of the options.

Conclusion

Davis is a good example of how Code Sec. 83 should function in practice. Despite Allen's receipt of income that probably put him well within the one percent, there seems little to criticize. The underlying tax treatment afforded Allen and CNG with respect to the option grant and exercise makes sense.

CNG's success was due in no small part to Allen's contributions. The Tax Court appears to have properly concluded that Allen should bear the tax burden associated with the income attributable to such success. However CNG, as a corporate entity, should also enjoy the tax deduction that correlates with Allen's income.

Truly, as Justice Black advises, taxation should be on net rather than gross income. As a corollary, Code Sec. 83(h) allows corporate entities to reap the benefit of the stock appreciation that accrues to their employees through option grants and exercises. Occupy Wall Street and its adherents may believe that such provisions make the tax code unfair to the 99 percent. However, whatever the equities of Code Sec. 83, its treatment of income and deductions is appropriately symmetrical.