Tax Effects of the Stock Options Backdating Flap

By Robert W. Wood

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The stock options backdating scandal has become prominent and pervasive. While perhaps none of us can be excused from some awareness of the controversy, the mind-numbing repetition of the headlines gives us an excuse for no longer noticing. All told, around 140 companies are now under investigation, and more are likely to come under fire. Prosecutors and corporate lawyers are scurrying around attacking or defending companies embroiled in this latest mess.

Yet, it seems hard to imagine that most of this scuffle would affect rank-and-file employees. Not true. Likewise, this may seem to be solely about securities law, earnings statements, and accounting rules, with no impact on taxes. Think again.

There seems to be something of an information gap. At least some highly paid executives and board members of companies involved in backdating (whether or not these individuals bore any responsibility for any wrongdoing) are well informed about the tax issues they now face. So far, though, companies are doing a poor job of disseminating information to affected employees. Even the IRS has not made the tax position of employees clear, unless their employer takes over and agrees to pay all taxes.

Nasty Names

First, some definitions. It is difficult to generalize about exactly what backdating really is, since there have been significant variations in fact patterns. Indeed, much of the debate centers on which practices are legitimate and which are not. Just about everyone realizes that it is wrong if a company issues options to an employee on March 1, 2007, but lies about the issuance date and *says* they were issued on March 1, 2006. But there are many closer calls.

For example, suppose a company hires a new employee on June 1, scheduling the worker to actually 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? Does it depend on questions of degree?

What about awards of options under which the 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?

As prosecutors and companies work through many of the issues, someone needs to advise option holders and stockholders about their stake in this mess. My focus here is on employees who may hold options (or who hold stock that was acquired through the exercise of options). Whether you are a rank-and-file employee, an executive, or a board member, these are tough issues. And they can affect your tax bill.

One more clarification about the taint of backdating. Although there are some well-publicized exceptions, the majority of executives and board members in companies implicated in these scandals probably had no knowledge that grant and exercise standards were being manipulated, or to put it less pejoratively, that they were being applied to maximize the benefit of the options to the optionee. Like highly paid executives and board members, rank-and-file option holders deserve some information about what the options backdating scandal will mean for them and, more particularly, for their tax bills.

Option Basics

Options give employees the right to buy shares at a specified price. If the stock price rises, the employee presumably will exercise the option and thus will get a bargain purchase. That will eventually lead to gains. If the company issuing the options breaks the law by backdating an option to a time when the stock price was even lower than the day on which the options were *actually* granted, the recipient gets an even better deal. Or so it would seem.

Talking further about the tax treatment of options requires one to distinguish between nonqualified options and incentive stock options because they are subject to two very different tax regimes. Stock options fall into two categories: nonqualified options and incentive stock options (the latter sometimes referred to as ISOs). With nonqualified options, there is generally no tax when the option is granted. Any appreciation from the grant date to the exercise date is taxed as ordinary income at the time of exercise.

With incentive stock options, however, there is no tax to the participant when the option is granted or when it is exercised. In fact, 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 some rules are met. With ISOs, one of the primary benefits has traditionally been that the appreciation in the shares is taxed as a capital gain instead of ordinary income. Plus, instead of tax due on exercise (which occurs with nonqualified options), tax is due on the sale of the shares.

Thus, incentive options are better from a tax viewpoint, in the sense that they are typically taxed only when the underlying shares are actually sold. Yet, there's a big exception to this favorable treatment because of the effects of the dreaded alternative minimum tax. When an employee exercises his 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 an AMT hit.

On exercise, the excess of the fair market value of the options over their exercise price is considered preference income subject to the AMT. Whether preference income is taxable depends on a variety of factors, including the taxpayer's other income. In some cases, though, the AMT can be a huge tax problem in the year ISOs are exercised.

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 AMT on this income will depend on her other income, other AMT items, the use of her AMT exemption, and so on.

Note that this AMT issue for ISOs exists in the year of exercise, even if the shares later become worthless. Many employees found this out the hard way in the wake of the bursting of the Internet bubble.

Section 409A Surtax

All of this should suggest that holders of stock options have their work cut out for them. Planning and compliance with stock option rules can be tough even if you don't have any issue of backdating. Backdating makes it worse. Much of the tax fear about option backdating problems comes from a provision of the tax code that you might think (at first glance) would be irrelevant to stock options.

Actually, it is a provision of the tax code that affects not only stock options, but also any kind of deferred compensation. A relative newcomer to the code, section 409A was added by the American Jobs Creation Act of 2004. In general, section 409A provides that, unless some requirements are met, amounts deferred under a nonqualified deferred compensation plan are currently includable in gross income. Plus, the amount includable in gross income is subject to some additional taxes.

Section 409A applies to some 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 section 409A. Triggering the section 409A rules means that not only the normal stock option amount is taxed, but an additional 20 percent income tax is also levied. 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 1 percent). That latter tax is often referred to as the interest tax.

It is bad enough that option plan participants need to understand the difference between nonqualified options and ISOs, and the difference between regular tax and AMT. Now they need to also worry about the additional 20 percent tax (plus interest) imposed by section 409A. Section 409A and its new taxes ought not to touch most stock options. But unfortunately, it is now clear that the complicated rules of section 409A do apply to options backdating problems.

Under section 409A and the IRS's explanatory rules adopted under it, improperly priced options of *either* sort — nonqualified or incentive — can trigger a 20 percent surtax, on top of already steep ordinary income tax rates. That means you can pay ordinary income tax plus a 20 percent surtax (plus interest). Those special taxes apply in the year an executive is first allowed to exercise options (that is, when the options vest), even if he 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.

These deferred compensation rules apply only to options that vested after 2004, which may provide limited relief. Moreover, the IRS has waived penalties for 2005. After that, however, you're supposed to be on notice.

Paradoxically, the section 409A rules regarding deferred compensation may have indirectly provided relief for some options backdating messes. Under the section 409A regulations, companies can replace improperly priced options with properly priced ones. For top officers, the deadline for that action was December 31, 2006. For other employees, companies will have until the end of 2007 to take that step.

Backdating and Taxes

Just how can backdating *help* (as opposed to hurt) an employee's tax position? Although most of the focus of the stock options backdating controversy has surrounded grants of options, the taint has recently spread to exercise dates as well. In fact, a Securities and Exchange Commission paper suggests that some executives have manipulated the exercise dates of their options. The goal of that exercise (excuse the pun) seems purely tax-motivated. The reason backdating of an exercise date might be tempting stems from the way in which the code treats different types of income.

Whether they are nonqualified options or ISOs, options give the employee a right to buy stock at a fixed price in the future. Often called the "strike price," that exercise price is usually the stock's market price on the day the options were granted. Often, when an employee exercises an option and thus acquires actual shares, he immediately turns around and sells the shares. With nonqualified options, that's extremely common. 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, however, the executive who exercises the options does not sell the stock immediately. To be clear, we again must differentiate between ISOs and nonqualified options.

Suppose you hold nonqualified options. If you exercise but then hold the shares for at least a year after the exercise, you may pay a far lower tax (capital gains tax rates are only 15 percent, compared with ordinary income rates of 35 percent). Because the employee will pay tax at only the 15 percent rate if he holds onto the stock for more than a year, serious money is at stake.

Example: Eric Executive holds nonqualified options on 100,000 shares with a strike price of $10. Suppose he exercises and sells the stock immediately thereafter when the price is $20 a share. That means he realizes $1 million in income and must pay ordinary income tax on his gain. At a flat 35 percent, he'd pay $350,000 in federal tax.

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

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 (in this example, the price on the date the options were issued) truly is.

Plus, the stock price on the date of exercise is of potentially even greater importance. That is why allegations of backdating of exercise dates may become the newest gambit in the stock options backdating mess.

Companies at Risk?

Although my focus here is on employees and their own tax problems occasioned by options dating controversies, it is worth noting that companies have their own set of concerns. I'm not referring here to the panoply of regulatory and securities laws issues (although those are substantial), but solely to tax issues. Companies, after all, can be penalized for failing to withhold on compensation. Because many stock options are compensatory, and payments to employees can constitute wages, the additional taxes, penalties, and interest can be huge.

Also, there are special wrinkles in the stock option area, quite apart from normal payroll tax issues. For example, companies must generally collect payroll taxes if incentive stock options do not meet specific conditions. Backdated stock options appear to be subject to this tax. Not only that, but the tax is probably due on the value of the options when they are exercised, not the value when they vest.

Some companies may find themselves in the position of having to pay those additional taxes — not only the employer's share, but the employee's share as well. The company may then try to collect the employee portion of those payroll taxes from its current (or former) employees.

New IRS Settlement Program

The IRS has announced a plan to help rank-and-file employees who owe taxes because they unwittingly received backdated stock options.[1] Remember, employees who received backdated options must pay the additional 20 percent tax, plus an interest element. The culprit is section 409A, enacted in 2004 to change deferred compensation rules. Put simply, the IRS program requires the employer to bear the entire tax burden of the backdating.

The IRS initiative is voluntary, and it proposes that companies with backdating problems pay the steep additional taxes due from lower-level employees who exercised backdated options in 2006. Remember, the IRS granted clemency for options issued in 2005.

Announced in early February 2007, the IRS program 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. The program applies only to options that vested in 2005 and 2006, and that were exercised in 2006. Early indications are that few companies are taking advantage of this program.

Companies are not allowed to resolve any of their top executives' taxes through this program. In other words, this program is designed for rank-and-file employees. Some companies, however, have taken steps to spare top executives from tax on any options they haven't yet exercised, by repricing the options to fix the backdating problems. In some cases, companies have even paid executives a special bonus to compensate them for the repricing.

State Tax Compliance, Too

In addition to considering the federal income tax effects of backdated stock options, companies as well as employees will need to consider state income tax rules. Many states (like my home state of California) conform to section 409A. Nevertheless, it is not clear what many states will do with this particular option backdating issue. Whether or not there is a similar state program, some companies will probably pay the state taxes, too.

Whether the taxes paid for employees are state or federal taxes, when companies pay the additional taxes (as the IRS program contemplates), that payment of tax on behalf of an employee probably will generate additional taxable income to the employee. That circular "tax on a tax" problem is likely to catch employees unaware.

Conclusion

Stock options backdating concerns are huge. The primary thrust of those concerns surely lies outside the tax realm. Nevertheless, tax considerations are increasingly going to play a part, both for companies struggling through these unfortunate circumstances and for the employees (and former employees) who actually receive the options. Whether or not the employees participated in any wrongdoing (and most clearly did not), the tax issues facing many of those employees are going to require professional help.

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[1] *See* Ann. 2007-18, 2007-9 IRB 1, *Doc 2007-3443, 2007 TNT 28-10.*