Hidden Taxes in Options Backdating Probe

By Robert W. Wood[1]

I. INTRODUCTION

The stock options backdating scandal has become prominent and pervasive. In fact, perhaps all of us can be excused for no longer noticing. All told, something approaching 140 companies are now under investigation, and more are likely to come under fire. Prosecutors and lawyers are scurrying around variously attacking or defending companies embroiled in this latest mess.

Yet, it seems hard to imagine that most of this scuffle would impact rank and file employees. Not true. Likewise, this may seem to be solely about securities law, earnings statements and accounting sales, 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. This is especially true for rank and file employees. Even the Internal Revenue Service ("IRS") has not made the tax position of employees clear.

A. 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 about this subject centers on which practices are legitimate and which are not. Just about everyone realizes that it is flat wrong if a company issues options to an employee on March 1, but lies about the issuance date and *says* they were issued on January 1. But there are lots of 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 where the board or compensation committee (as appropriate) takes all necessary action to grant options, but the resolutions are not fully signed by all necessary parties for two weeks? Is it backdating if a straggler signatory signs the grant 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 these 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 impact your tax bill.

One more clarification about the taint of backdating. Although there are some well-publicized exceptions, the vast 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 rank and file option holders, highly paid executives and board members deserve some information about what the options backdating scandal will mean for them and, more particularly, for their tax bills.

B. 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, since 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 "ISOs"). With nonqualified options, there is 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, on the other hand, 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 certain rules are met. With ISOs, one of the primary benefits has traditionally been the fact 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 is a big exception to this favorable treatment because of the effects of the dreaded alternative minimum tax (or AMT). 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 is 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 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 1000 shares of Tech, Inc for $10 per share. The stock goes up to $20, and Emily exercises, purchasing 1000 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% AMT tax on this income will depend on her other income, other AMT items, the use of her AMT exemption, etc.

Note that this AMT issue for incentive stock options 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.

C. 409A Surtax

All of this should suggest that holders of stock options have their work cut out for them. Planning and compliance can be tough even if you do not have any issue of backdating. Backdating makes it worse. Much of the tax terror about option backdating problems comes from a provision of the Internal Revenue Code ("Code") that you might think (on first glance) would be irrelevant to stock options.

Actually, it is a provision of the Code that impacts not only stock options, but also any kind of deferred compensation, and it is a relative newcomer to the Code. Section 409A was added to the Code by the American Jobs Act of 2004. In general, §409A provides that, unless certain 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 certain additional taxes.

Section 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 date of grant. When the option is exercised, it is treated as an impermissible payment of nonqualified deferred compensation under §409A. Triggering the §409A rules means that not only the normal stock option amount is taxed, but an additional 20% 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%). This 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 alternative minimum tax. Now, they need also to worry about the 20% excise tax imposed by §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 §409A do apply to options backdating problems.

Under §409A and the IRS's explanatory rules adopted under it, improperly priced options of *either* sort can trigger a 20% surtax, on top of already steep ordinary income tax rates. That means you can pay ordinary income tax plus a 20% surtax (plus interest). This special tax applies in the year an executive is first allowed to exercise options (thus, 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. Moreover, the IRS has waived penalties for 2005. After that, though, you are supposed to be on notice.

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

II. BACKDATING AND TAXES

Circling back to the backdating scandal, just how could 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, an SEC 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 denominated a "strike price," this exercise price is usually the stock's market price on the day the options were granted. Often, even though the executive may exercise the option and thus acquire actual shares, the executive then immediately turns around and sell the shares. With nonqualified options, this is 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, though, 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 have nonqualified options. If you exercise but then hold on to the shares for at least a year after the exercise, you may pay a far lower tax (capital gains tax rates are only 15%, compared to ordinary income rates of 35%). The fact that the executive will pay tax at only the 15% rate if he or she holds onto the stock for more than a year means that serious money is at stake.

> *Example:* Eric Executive holds nonqualified options on 100,000 shares with a strike price of $10. Supposed that he exercises and sells the stock immediately when the price is $20 a share. That means he realizes $1,000,000 in income and must pay ordinary income tax on his gain. At a flat 35%, 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 will pay only $60,000 in capital gains tax. That means his total tax is $270,000, not $350,000. In both situations, Eric has the same $1,000,000 gain, but he has saved $80,000 in taxes.

A key element, of course, is what the strike price (in the above example, the price on the date the options were issued) truly is. Moreover, of potentially even greater importance, what is the stock price on the date of exercise? The above example shows why allegations of backdating of exercise dates may become the newest gambit in the stock options backdating mess.

III. COMPANIES AT RISK?

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

There are special wrinkles in the stock option area, quite apart from the normal payroll tax issues. For example, companies must generally collect payroll taxes if incentive stock options do not meet certain conditions. Clearly, backdated stock options would 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 these 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 from its current or former employees.

IV. 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. Remember, employees who received backdated options must pay the additional 20% excise tax, plus an interest element, as a result of the 2004 changes in deferred compensation rules. Put simply, the IRS plan requires the employer to bear the burden of the backdating. The IRS initiative is voluntary, and proposes that companies with backdating problems pay the steep additional taxes due from lower level employees who exercised backdated options in 2006.

Announced in early February 2007, the IRS only gave companies 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 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. Some companies, however, have taken steps to spare them from tax on any options they have not 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.

V. 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 Code §409A. Nevertheless, it is not clear what many states will do with this particular option backdating issue. About the only thing that is certain is that when companies pay the additional taxes (which the IRS program contemplates), that payment of tax on behalf of an employee, in turn, generates additional taxable income to the employee. This circular problem is likely to catch taxpayers unaware.

VI. CONCLUSION

All in all, employee options backdating concerns are huge. The primary thrust of these concerns may lie outside of the tax realm. Nevertheless, increasingly, tax considerations are 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), there may be tax issues facing the employees that require professional help.

ENDNOTES

1. Robert W. Wood practices law with Wood & Porter, in San Francisco (www.woodporter.com), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. Tax Institute 2005 with 2007 Update) available at www.damageawards.org. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.