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Addressing the Tax Implications of Discounted Stock Options

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Backdating or discounting of options

As the problem of discounted stock option grants by public companies continues to be featured in the news and investigated by federal agencies, what initially appeared to be an issue that might affect only a few technology companies may wind up affecting hundreds of public companies and their employees.

A discounted option is an option whose exercise price stated in the grant documents is lower than the actual fair market value of the shares on the date that the grant was legally completed and effective.

There are several scenarios that can produce so-called "discounted options." On one end of the spectrum are companies that engaged in deliberate backdating; such companies decided to make a grant to employees and simply dated the grant documents with a prior date when the stock price was lower. On the other end of the spectrum are situations where necessary parties agreed on a certain date to make grants on that date, but the required corporate approvals were not obtained, and thus the grant was not effective until a later date. Somewhere in the middle of the spectrum is the situation where members of the stock option committee agreed to grant options on a particular date, but the actual amounts granted to each employee were not worked out until later. All of these situations could result in a discounted option.

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Executives, middle managers, and other employees of small to medium-sized companies who possess stock options that did not vest prior to 2005 should be most concerned about discounted options and their potential tax implications. Employees can inquire whether they have been granted any discounted options, but it may be some time before their companies conclude any investigations to determine which options are discounted and what the companies plan to do to remedy the problem. Because of the timing rules discussed below, most companies are presently planning to effect such remedies in 2006, but it may turn out to be close to the end of this year.

If an employee's company has announced that it knows of or is investigating the possibility of discounted options, the employee may want to start thinking now about the potential income tax issues that could arise. Unfortunately, Internal Revenue Service guidance is unclear or lacking in several important respects. But there are some basic laws and rules that employees may well want to consider now.

Internal Revenue Code Section 409A

There are several tax issues that could arise if a company determines that option grants were discounted, but probably the most important tax issue for executives and employees who received discounted options will be Section 409A of the Internal Revenue Code.

Section 409A, adopted as part of the American Jobs Creation Act of 2004, provides that amounts deferred by an employee under a "nonqualified deferred compensation plan" must comply with new rules regarding the timing of the deferral and the distribution of the deferred amounts.

Stock options are generally considered a form of deferred compensation unless, among other conditions, they are granted at an exercise price that is not less than the fair market value of the stock on the date of grant. If granted at a discount, the stock option would have to provide that it could be exercised only at fixed times in order to comply with the rules of Section 409A. However, most stock options provide that they may be exercised any time after the option has vested.

Effective date of Section 409A

Section 409A generally became effective Jan. 1, 2005. The law is potentially applicable to discounted options which have no fixed exercise dates and which were:

- Granted on or after Jan. 1, 2005; or
- Granted before 2005 but not fully vested before 2005, or materially modified after Oct. 3, 2004.

In addition, under transition rules provided by the Internal Revenue Service, options that were exercised or otherwise terminated before 2006 will not be subject to Section 409A.

Penalties

If Section 409A applies, the discounted option would be taxable on the date it vests (even if not exercised) and the holder of such option could also be subject to a 20% penalty tax (in addition to regular income tax) plus interest which might accrue every year from the date of grant or vesting until the holder exercises the option or the option expires. To date, the Internal Revenue Service has not issued guidance on the calculation of penalties. Pending future guidance, the amount subject to the penalty could be based on the value of the option measured on the date of grant or the date of vesting, plus increases in that value through the date of exercise. The value of the option might be the excess of the value of the stock over the exercise price, or the "fair value" of the option determined under a Black-Scholes or similar valuation methodology.

Remedies

Many companies will be looking to resolve the Section 409A issues before the end of 2006 because of temporary transition relief scheduled to expire this year. If an employee's company has not yet concluded its investigation and announced a company plan for remedying a section 409A issue, if any, the employee may have to wait until closer to the end of the year to see how the company chooses to handle the issue and/or to see if the Internal Revenue Service issues an extension of the temporary transition relief or provides other guidance. (Of course, there may be other factors—for example, cash needs or a view that the stock price will decline in the next few months—which would require or suggest that the employee should not wait for further developments.)

Here are ways in which companies are attempting to remedy the Section 409A problem during 2006:

- Some companies are offering to amend the old options to increase the exercise price to the fair market value of the stock on the legal date of the grant. These companies may provide employees with some kind of compensation as part of this remedy. Under Internal Revenue Service rules, any compensation to employees in consideration of the increase in the exercise price of stock options cannot vest or be paid until 2007 or later.
- Some companies have offered to amend the discounted options to require that they be exercised at fixed times in the future. The fixed exercise time may be any year prior to the expiration date of the option (for example, the year in which the option vests), but if the employee chooses not to exercise the options in the designated year they would have to be forfeited. While this solution may comply with Section 409A, it may not be an attractive solution for the employee, because the stock price may fall and the fixed period chosen for exercise may turn out to be an unfavorable time for exercising the options.

Pending further guidance, it may be too late to correct discounted options already exercised during 2006.

Companies and employees should keep in mind that until final regulations or other guidance becomes available, the tax implications under Section 409A will remain unclear. It is also possible that the Internal Revenue Service will provide further transition relief. For example, it is possible that the Internal Revenue Service will allow optionees additional time to exercise discounted options and avoid the application of Section 409A. The American Bar Association as well as the American Institute of Certified Public Accountants have asked Congress to hold hearings on the repeal or substantial narrowing of Section 409A because of its far-reaching and unintended consequences.

Other tax consequences

If an employee exercised options *intended* to qualify as ISOs, but the options could not qualify as ISOs because the options were actually discounted options, the employee may be subject to additional income and employment taxes (and late payment penalties and interest), and the employer may be subject to liability for failure to withhold and report.

Tax treatment if qualified as ISO: Upon the exercise of an ISO, the employee does not recognize compensation income, and the employer is not required to report or withhold income or employment taxes. Upon the sale of ISO shares after completion of the necessary ISO holding periods (i.e., more than two years from the grant of the option and one year from the exercise), all of the income is taxed at the favorable long-term capital gains rate. If either holding period is not met, a portion of the gain—equal to the excess of the value of the stock on the date of exercise over the exercise price—is taxable to the optionee as compensation income.

Tax treatment if not an ISO: Upon the exercise of an option that does not qualify as an ISO, the employee recognizes compensation income equal to the excess of the fair market value of the stock on the date of exercise over the exercise price. The employer is required to report the income and withhold applicable income and employment (FICA/FUTA) taxes.

Loss of ISO status could therefore affect the amount and timing of taxes owed by the employee.

Members of Pillsbury Winthrop Shaw Pittman's Stock Options Task Force can:

- Assist companies in responding to Securities and Exchange Commission, Internal Revenue Service, or any U.S. Attorney's Office request for information.
- Assist companies in conducting internal investigations or assist in investigations by an independent committee.
- Defend companies in derivative and class actions.
- Represent officers, directors, or employees facing civil or criminal enforcement actions.
- Represent employees with their tax and executive compensation issues.

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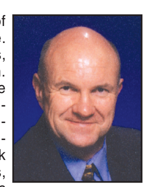
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