

**Authors: Jeffrey W. Kroh
and J. Rose Zaklad**

If you have any questions,
please call one of the
following, or the Groom
attorney you regularly
contact:

Jeffrey W. Kroh
jkroh@groom.com
(202) 861-5428

Louis T. Mazawey
lmazawey@groom.com
(202) 861-6608

John F. McGuiness
jm McGuiness@groom.com
(202) 861-6625

Brigen L. Winters
bwinters@groom.com
(202) 861-6618

J. Rose Zaklad
jzaklad@groom.com
(202) 861-6626

Federal Claims Court Upholds IRS Position on Discounted Stock Options

It appears the IRS may be starting to go after easy targets under section 409A of the Internal Revenue Code ("409A"), including discounted stock options. In *Sutardja v. United States*,¹ the Court of Federal Claims confirmed that 409A applies to a discounted stock option (i.e., a stock option granted with an exercise price less than fair market value on the grant date) when it ruled in favor of the United States on several key 409A issues on summary judgment. The case is summarized below, along with a few general observations.

Background

On December 26, 2003, the compensation committee of Marvel Technology Group Limited (the "Company") approved a nonqualified stock option grant to the Company's President and Chief Executive Officer ("CEO") covering 1.5 million shares, which was subsequently ratified on January 16, 2004. The CEO exercised a portion of this option in January 2006, which was followed by an internal review of the Company's stock option grant practices. As a result of this review, the CEO entered into a reformation agreement with the Company to repay the discounted portion of the stock option. In 2010, CEO and his wife ("Plaintiffs") received a Notice of Deficiency from the IRS for the 2006 tax year, assessing an additional 20% tax, plus interest for a 409A violation in connection with the option exercise. The Notice of Deficiency was based on the IRS assertion that the exercise price for the stock option was lower than the share price on the January 16, 2004 ratification date.

The ultimate outcome of the case is still undecided, as the Court did not rule on the factual issue of whether the exercise price was below fair market value on the grant date. However, in the process of narrowing the case for trial, the court ruled in favor of the United States on all four of the Plaintiffs' arguments for exemption from 409A.

409A Applies to Discounted Stock Options

First, the court agreed with the IRS's position in Notice 2005-1 (and all subsequent 409A guidance from the IRS) that if a stock option is granted with an exercise price of less than the fair market value on the grant date, the option is "deferred compensation" subject to 409A. The court was not convinced by Plaintiffs' argument that this definition of deferred compensation was contrary to Supreme Court jurisprudence.

FICA Regulations Do Not Control

Next, the court rejected Plaintiffs' argument that the definition of "deferred compensation" under the special FICA rules (Code § 3121(v)) on nonqualified deferred compensation should control for purposes of 409A. In making its determination, the court noted that the FICA

¹ No. 11-724T (Fed. Cl. Feb. 27, 2013).

regulation's exclusion of stock option grants from the definition of deferred compensation applies only for purposes of determining FICA taxes, but does not apply for 409A purposes. Both the language of the FICA and 409A regulations are consistent with the limited applicability of this exclusion.

“Legally Binding Right”

Plaintiffs further argued that 409A would not apply to a discounted stock option until exercise, because there was no “legally binding right” to compensation until such time, and therefore no deferral of compensation to a later year. Again, the court disagreed and concluded that a legally binding right to compensation arose when the stock option vested.

Short-Term Deferral Exemption

Finally, the court rejected Plaintiffs' argument that any deferral of income related to the discounted stock option should be exempt from 409A as a “short-term deferral” under Notice 2005-1. Under the short-term deferral exemption, as set forth in Notice 2005-1, the terms of the plan must require payment by, and the amount must actually be received, no later than 2 ½ months after the year in which the amount is no longer subject to a substantial risk of forfeiture. The court held that, even though the stock option ultimately was exercised within 2 ½ months after the year in which it vested, the option agreement did not require the CEO to exercise the stock option within that time period. Instead, the option agreement permitted him to exercise his option at any time during the stock option's 10-year term. As a result, the court ruled that the short-term deferral exemption was not available to exempt the discounted stock option from 409A.

General Observations

This is the first reported case where 409A penalties were assessed and pursued by the government. In addition, the facts are significant due to the periods involved. The Company granted these stock options before 409A was even enacted, and the CEO exercised them during the “good-faith” 409A transition period that lasted through 2008. Until now, many practitioners have been operating under the assumption that, before January 1, 2009, there may have been some IRS leniency in enforcement based on the good-faith operational compliance standard that applied in this timeframe. However, the strict enforcement of 409A in this case warrants reconsideration on this point, especially in light of the Plaintiffs' attempted self-correction through a reformation agreement.

Although Plaintiffs may prevail on factual issues at trial, the IRS likely will be pleased with the court's legal reasoning in this opinion, with one exception – the IRS likely would identify the grant date as the date a “legally binding right” to the stock option arises for purposes of 409A.

Going forward, employers should carefully document the process for determining the fair market value of their stock and related option exercise prices in accordance with the final 409A regulations, and should establish stock option grant procedures to avoid any potential disputes in the future.