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View From Groom: Discounted Stock Options in the Cross-Hairs of Section 409A Compliance

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It appears the Internal Revenue Service may be starting to go after easy targets under Section 409A of the Internal Revenue Code, including additional taxes on discounted stock options totalling almost $3.5 million. In *Sutardja v. United States*,[1] the Court of Federal Claims confirmed that Section 409A applies to a discounted stock option when it ruled in favor of the United States on several key issues determined on summary judgment. We provide below a summary of the relevant Section 409A rules and the recent development in *Sutardja*, along with a few general observations.

[1] *Sutardja v. United States*, No. 11-724T (Fed. Cl. Feb. 27, 2013) (41 PBD, 3/1/13; 40 BPR 536, 3/5/13).

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Overview

Section 409A was enacted in 2004 as part of the American Jobs Creation Act.[2] Section 409A applies to ''nonqualified deferred compensation,'' which is broadly defined to potentially cover many types of compensation arrangements, including discounted stock options (i.e., an option granted with an exercise price less than fair market value on the grant date).[3] Prior to the issuance of regulations under Section 409A, the IRS issued Notice 2005-1, which stated that if a stock option is granted with an exercise price of less than the fair market value of the company's stock on the grant date, the option is ''deferred compensation'' and subject to Section 409A.[4] Importantly, this same rule regarding the scope of Section 409A was confirmed by its inclusion in Section 1.409A-1(b)(5) of the final regulations.

In addition, Notice 2005-1 provided that taxpayers should apply a ''good-faith,'' reasonable interpretation of the statute and the notice during the transition period, pending the issuance of further guidance.[5] Even under this seemingly more flexible compliance standard, *Sutardja* confirms that not even discounted stock options granted prior to the enactment of the statute are

[2] American Jobs Creation Act of 2004, Pub. L. No. 108–357, 118 Stat 1418.
[3] Treas. Reg. § 1.409A-1(b)(5).
[4] Notice 2005-1, 2005-2 I.R.B. 274, Q&A-4(d)(ii).
[5] *Id.*, Part II.

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immune from the adverse tax consequences associated with a violation of Section 409A.

Section 409A Rules

Deferred compensation under Section 409A is defined to include, unless an exception applies, any right to a payment in a future tax year. Typically, a nonqualified stock option is structured to be exercisable during its term at any time after vesting, and upon exercise, the option holder recognizes income equal to the difference between the exercise price and the fair market value of the underlying stock on the exercise date. Due to this ability to exercise in more than one year, a stock option that is subject to Section 409A generally will not be compliant.

If the requirements of Section 409A are violated, all amounts deferred by the participant under that type of plan[6] (e.g., all nonexempt stock options and stock appreciation rights) are taxed immediately or upon the lapse of a substantial risk of forfeiture (i.e., vesting), if later.[7] In addition to immediate taxation, Section 409A imposes a 20 percent additional tax on the amount of compensation that is required to be included in income, plus interest at the IRS underpayment rate plus one percent (hereinafter the Adverse Tax Consequences).[8]

Fortunately, Section 409A specifically provides an exception from its definition of deferred compensation for stock options that meet certain requirements. Essentially, the grant of a nonstatutory stock option (also known as a nonqualified stock option) is exempt from Section 409A if, among other requirements, the exercise price may never be less than the fair market value of the underlying stock on the grant date.[9] To establish a Section 409A-compliant exercise price, a company must properly (1) identify the grant date of the option, and (2) establish the fair market value of the underlying stock on that date.[10]

Recent Development: *Sutardja v. United States*

On Dec. 26, 2003, the executive 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 that was subsequently ratified on Jan. 16, 2004. The CEO exercised a portion of this stock option in January 2006, which was followed by an internal review of the Company's stock option granting practices. As a result of this review, the CEO entered into a ''Reformation of Stock Option Agreement'' and paid an additional amount to the Company, representing the discounted portion of the exercised stock option.

In 2010, the CEO and his wife (Plaintiffs) received a Notice of Deficiency from the IRS for the 2006 tax year, assessing the Adverse Tax Consequences for a Section 409A violation in connection with the stock 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 Jan. 16, 2004, ratification date.

The outcome of this case remains undecided because the court has yet to 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' legal arguments for exemption from Section 409A, as summarized below.

Section 409A Applies to Discounted Stock Options. First, the court found that Notice 2005-1 (and all subsequent Section 409A guidance), which provides that discounted stock options are subject to Section 409A, is consistent with the Supreme Court jurisprudence in *Comm'r v. Smith*.[11] Generally, *Smith* held that a nondiscounted option was not taxable until exercise. This court noted that *Smith* did not extend to discounted stock options and thus, the application of Section 409A to a discounted stock option pursuant to Notice 2005-1 was not contrary to Supreme Court jurisprudence, as argued by Plaintiffs.

FICA Regulations Do Not Dictate the Scope of Section 409A. Next, the court rejected Plaintiffs' argument that the definition of ''deferred compensation'' under the special FICA rules on nonqualified deferred compensation should control for purposes of Section 409A.[12] The court noted that the FICA 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 Section 409A purposes. The language of the FICA and Section 409A regulations are both consistent with the limited applicability of this exclusion.

Legally Binding Right. Plaintiffs further argued that Section 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. The court disagreed, finding 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 Section 409A as a short-term deferral under Notice 2005-1. Under the short-term deferral exemption, as set forth in the notice, 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.[13] The court held that, even though the stock option ultimately was exercised within 2 ½ months af-

[6] Treas. Reg. § 1.409A-1(c)(2)(i)(H).
[7] I.R.C. § 409A(a)(1)(A).
[8] I.R.C. § 409A(a)(1)(B).
[9] Note that a grant of a statutory stock option, including an incentive stock option or an option granted under an employee stock purchase plan (as described under I.R.C. §§ 422 or 423, respectively), is exempt from Section 409A. Treas. Reg. § 1.409A-1(b)(5)(ii).
[10] The final regulations under Section 409A provide guidance on how to identify the grant date and establish fair market value. *See* Treas. Reg. §§ 1.409A-1(b)(5)(vi)(B) and -1(b)(5)(iv).
[11] *Comm'r v. Smith*, 324 U.S. 177, 65 S. Ct. 591, 89 L. Ed. 830 (1945).
[12] Treas. Reg. §§ 31.3121(v)(2)-1(b)(3)-(4).
[13] Notice 2005-1, Q&A-4(c).

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ter 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 stock option agreement permitted him to exercise this stock option at any time during its 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 Section 409A.

General Observations

This case is notable for a number of reasons, including that it is the first reported case to address Section 409A issues regarding discounted stock options and the first reported case in which the government assessed and pursued the Adverse Tax Consequences under Section 409A. In addition, we discuss below a few other general observations.

Events Occurred in Good-Faith Period. The facts in *Sutardja* are significant due to the period involved. The Company granted these stock options before Section 409A was even enacted, and the CEO exercised them during the good-faith Section 409A transition period that lasted through 2008. Until now, many practitioners have been operating under the assumption that prior to Jan. 1, 2009 (the effective date of the final regulations under Section 409A), there may have been more flexibility based on the good-faith, reasonable interpretation standard set forth in Notice 2005-1 and subsequent guidance that applied in this timeframe. However, the government's strict enforcement in light of the Plaintiffs' attempted self-correction and its pursuit of Adverse Tax Consequences under Section 409A in this case warrants reconsideration on this point.

Potential California State Tax Consequences. California applies rules similar to those under Section 409A to the taxation of nonqualified deferred compensation for state income tax purposes. The state tax rules can result in an additional 20 percent penalty tax for California residents experiencing a Section 409A violation.[14] In December 2009, the Plaintiffs, as California residents, received a Notice of Proposed Adjustment proposing to treat the stock options exercised in 2006 as a Section 409A violation under California law. It appears this additional California state tax assessment may be pending the outcome of the underlying factual issues in *Sutardja*. In the meantime, however, the Plaintiffs have filed a separate suit in California challenging the validity of the California Franchise Tax Board's interpretation of California's Section 409A piggyback tax rules.

Timing for Legally Binding Right. Although Plaintiffs may prevail on the factual issue to be addressed at trial, the IRS likely will be pleased with the court's legal reasoning in this opinion, except with respect to its ''legally binding right'' analysis. While the court's determination here did not impact the ultimate result, we believe the IRS would identify the grant date (not the vesting date) as the date a legally binding right to the stock option arises for purposes of 409A based on Treasury Regulation Section 1.409A-1(b)(1).

Next Steps

Going forward, based on this added pressure to make grants at fair market value, 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 regulations under Section 409A, and
- establish and consistently follow stock option grant procedures to avoid any potential disputes in the future.

[14] Cal. Rev. & Tax. Code §§ 17501, 24601 (West).