Tax Alert

IRS Targeting Backdating Issue

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Overview

On July 11 the IRS released an internal Industry Director Directive memorandum dated June 15, 2007 (the "Directive"), which designates transactions involving backdated stock options as a "Tier I Issue" for IRS agents. Tier I Issues are considered matters of "high strategic importance,"[1] and are subject to specialized enforcement within the IRS's Large and Mid-Size Business Division ("LMSB").[2] The Directive has important implications for both companies and individuals.

The IRS's interest in the tax implications of backdated options is not new. We are currently working with a number of clients that have already received Information Document Requests ("IDR") from the IRS requesting information relating to the backdating issue. The Directive is significant, nonetheless, in that it signals a nationally coordinated effort within the IRS to target transactions involving backdated stock options, and also establishes mandatory audit requirements and centralized reporting procedures within the IRS as relating to backdated stock options. As noted below, the directive also signals the IRS's intention to pursue the issue against individuals who received such options.

Designated as a Tier I Issue, IRS field agents are now required to audit all transactions involving backdated stock option grants and/or backdated exercise prices. The Directive also expands the categories of options that trigger special attention to include any options that might be discounted, mis-priced, mis-dated, or in-the-money. Furthermore, the Directive states the special requirements apply regardless of whether the issue arises from error or was the result of deliberate actions.

Important Implications for Individuals

The Directive instructs agents to identify the existence of any backdating issues at the beginning of any corporate examination. This instruction concerning timing is significant. The Directive states that the backdating issue should be identified early in the audit process so as to "ensure proper statute [of limitations] procedures are in place to address this issue at the individual level."

Thus, the Directive signals that the IRS intends to use its audits of corporate taxpayers as a tool for the timely identification of individuals who have benefited from backdating so that the IRS can pursue separate audits of such individuals before any relevant statute of limitations lapse.

Tax Implications

There are three principal tax issues associated with the backdating issue. Each of these three issues is identified and discussed briefly in the Directive.

First, backdated options raise deductibility issues pursuant to § 162.[3] Section 162(m) generally places a $1 million per-employee annual limit on the deduction allowed for compensation paid to the CEO and the four highest compensated officers[4] of a publicly traded company. An exception to this limitation is set forth in Treas. Reg. § 1.162-27(e)(2)(vi), which exempts "qualified performance based compensation" from the $1 million limitation. In order to qualify for this exception, the option in question must have an exercise price that equals or exceeds the per share value on the grant date (other requirements also apply). Backdating of an option may prevent it from qualifying for the exception set forth in Treas. Reg. § 1.162-27(e)(2)(vi).

The second tax consideration identified in the Directive focuses on whether an option qualifies as an Incentive Stock Option ("ISO") pursuant to § 422. Backdating of a stock option might prevent such option from qualifying as an ISO as § 422(b)(4) requires that the option's exercise price be not less than the fair market value of the stock at the time such option was granted. Withholding issues may arise for a corporation if an option that was labeled an ISO is later found to have been misclassified. Additional taxes could

1 Internal Revenue Manual § 4.51.5.1

2 LMSB has jurisdiction over corporate taxpayers (and related flow-through entities) with assets greater than or equal to $10 million.

3 All section references used herein refer to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder.

4 As an aside, generally the CFO will be excluded from this group per IRS Notice 2007-49.

also be triggered for the employee (requiring tax withholding by the employer) upon exercise of a disqualified option (and taxes may have been overpaid in prior tax years, requiring preparation of amended returns, due to misclassified option exercises made in those years).

The third tax issue identified in the Directive relates to § 409A, which applies to any discounted stock options granted after December 31, 2004, as well as any earlier-granted discounted stock options, with either: (a) vesting occurring after December 31, 2004, or (b) terms that are materially modified after October 3, 2004. The consequence of a discounted stock option being subject to § 409A is that the optionholder recognizes taxable income as the option vests (and thereafter), whether or not the option has been exercised (in other words, whether or not the optionholder has actually obtained any value from the option). This additional taxable income will be subject to a 20%+ federal tax in addition to the regular tax rate, plus regular state income taxes (and possibly additional state penalty taxes). In particular, California takes the position that its tax code imposes a parallel tax to that imposed by § 409A, with the result that the income deemed recognized may be taxed at an aggregate rate (U.S. + CA) as high as 85%+. It is important to note that taxpayers generally have until December 31, 2007, to amend their discounted stock options to comply with § 409A (generally by increasing the exercise price to what was fair market value on the date the option was granted), but any pre-amendment exercise made in 2007, however, are subject to § 409A taxes. With respect to options granted to certain executives subject to the disclosure requirements of Section 16(a) of the Securities Exchange Act of 1934, the transition relief to cure disqualified options was only available through December 31, 2006.

Form IDR Targeting Backdated Stock Options

The Directive includes a form IDR for use in any audit of backdated options. The form IDR set forth in the Directive is designed to allow the IRS to leverage off of backdating investigations and information previously provided by taxpayers to the SEC in connection with backdating issues.

For instance, the form IDR instructs the company to provide copies of final or preliminary SEC reports or filings, internal audit reports, independent investigation reports, and any other reports relating to the company's practices concerning the grant or exercise of stock options, including the backdating of stock options.

Further, the form IDR requires the company to identify information relating to individuals who may have benefited from backdating. Specifically, the form IDR requires the company to provide the names and positions of each individual who exercised stock option grants during the years under examination, including: (i) the date the necessary corporate action was completed for the grant of each stock option; (ii) the effective date (or backdate) of the stock option grant; (iii) the fair market value of the underlying stock on each of the aforementioned dates; (iv) the exercise price for each stock option grant; (v) the exercise date for each stock option grant; (vi) the fair market value of the underlying stock on the exercise dates; and (vii) the income tax deduction claimed for compensation reported on exercised options, including § 162(m) computations.

As drafted, the form IDR is unnecessarily broad and could be interpreted to require the disclosure of needless information. We have found the IRS receptive to amending the request to a more specific set of documentation which addresses the IRS's goals. Because the on-going possibility of securities litigation, it is important to carefully manage all responses to the IRS audit so as to avoid any waiver of the attorney-client privilege or the attorney work product privilege.

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