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Tax Urgency for Backdated (or Misdated) Stock Options: 409A Penalties Absent Action in 2006

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On October 4, 2006, the Treasury Department and the IRS signaled their intent to apply penalties under Section 409A of the Internal Revenue Code (Code) to those who have received stock options or stock appreciation rights (aka SARs) that –

1. were granted by a corporation that had registered equity securities with the SEC,¹
2. were granted to Section 16 reporting persons,
3. had an exercise price that was below-market on the grant date, and
4. caused the granting corporation to report (or to reasonably expect to report) a financial expense that “was not timely reported on the corporation’s financial statements or reports for the period in which the related expense should have been reported under generally accepted accounting principles” (GAAP).²

(Source: Notice 2006-79.)

These stock options and SARs are referred to below as “Misdated Grants,” for the reasons explained in Q&A-6 below. What is critical at the moment is a window period – from now until the end of 2006 – within which it is possible to amend Misdated Grants to bring them into compliance with Code Section 409A. Because the opportunity to avoid 409A tax penalties will end on December 31, 2006, companies and executives should immediately assess their exposure to risk.

Those who discover (or have) Misdated Grants will need to act promptly, yet carefully, to consider securities law disclosure obligations, financial accounting issues, available tax strategies, and the reaction of shareholders, the SEC, and other government regulators.

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Who Should Act?

For any company that has announced a financial restatement due to backdating or misdating reasons, prompt action would seem warranted. The premium on action in 2006 is also worth considering for any company that has reason to believe a backdating or misdating may cause a future restatement of its financials. In the latter instance, the company will need to weigh the implications of a 409A disclosure against the likelihood that it will trigger attention that would otherwise never have occurred if the company’s internal investigation determines that there has not been a past backdating or misdating.

Corrective action would be necessary for any Misdated Grants that were granted (or vested) after December 31, 2004. Misdated Grants that were granted and fully vested before January 1, 2005 would not be subject to Code Section 409A, but they would be subject to the other tax problems noted in Q&A-5 below (as well as to securities violations). Action before year-end 2006 merely avoids Code Section 409A problems, meaning the deadline should prompt immediate attention that is taken only after careful consideration of the broad range of implications that could arise from actual or possible backdated or misdated grants.

What 409A Corrective Alternatives Are Available?

Notice 2006-79 does not affect the 409A corrective alternatives that are available for the remainder of 2006. As a result, Misdated Grants are subject to any of the following remedies:

- (a) Increase the Exercise Price – to fair market value on the grant date. This is the simplest. The holder may receive consideration for the “lost” value arising from the increased exercise price in the form of a cash or stock-based award that is paid or vests after 2006.
- (b) Cash-out the Misdated Grant – through a post-2006 payment of a cash amount (or amounts), such as the Black-Scholes value of the surrendered grant.

- (c) Replace the Misdated Grant – with restricted stock or units, with deferred share units, or with a new stock option or SAR that has an exercise price equal to today's fair market value.
- (d) Conform the Misdated Grant to 409A – through imposition of a fixed payment date that applies regardless of when exercise occurs.

What Are the Public Disclosure Implications of the Above Alternatives?

If a 409A correction occurs with respect to a named executive officer (NEO) for proxy statement purposes, disclosure could be required in both an SEC 8-K (if the event is material and inconsistent with a previously filed form) and in the 2007 proxy statement. If the correction occurs for other officers, the same SEC 8-K standard would apply, but proxy statement disclosure would be less.

Whatever the reason for a 2006 or 2007 disclosure, it could signal to shareholders, auditors, and to government regulators that the company has a backdating or misdating problem. Suspicion is most likely if the correction involves cash-out of a stock option or an increase in its exercise price. On the other hand, because many companies are switching from stock options to restricted stock, such an exchange program may be subject to disclosure with less risk of triggering a public overreaction – subject to the overarching principle that the disclosure be complete and accurate.

What if a Misdated Grant Violates Section 409A?

The tax urgency arising from Notice 2006-79 is best understood through consideration of the consequences of violating Code Section 409A. Until the release of final 409A regulations, there will be some uncertainty about the exact calculation of the extra taxes that 409A imposes on noncompliant stock options and SARs. The following example makes reasonable inferences about what to expect based on current 409A guidance and informal comments from Treasury Department officials.

Suppose the following facts relate to the grant of a stock option or SAR to a Section 16 reporting person:

Number of Shares:	200,000 shares
Exercise Price:	\$10 per share
Date Determined:	January 1, 2005 (date on which exercise price was set)
Date of Grant:	January 4, 2005 (actual grant date, due to backdating or mis-dating)

Value on Grant:	\$12 per share
Vesting:	100% on date of award (to simplify this example)
Value on 12/31/07:	\$15 per share

The grant described above would be a Misdated Grant for purposes of Notice 2006-79, because its exercise price (\$10 per share) was below fair market value (\$12) on the date of the actual grant. Absent corrective action before the end of 2006, this Misdated Grant would trigger Code Section 409A penalties in 2007. The holder could become subject to the following tax consequences at the end of 2007, or the earlier date of exercise:

Ordinary Income:	\$1,000,000, which equals the product of 200,000 shares and the excess of the FMV (\$15) over the exercise price (\$10).
409A Additional Tax:	\$200,000, which equals 20% of the year end in-the-money value.

If the Misdated Grant continues to be outstanding at the end of 2008, and the per share fair market value increases another \$5 per share (to \$20), the holder of the Misdated Grant would be subject for the 2008 tax year to the same ordinary income and additional 409A taxes.

Is a Misdated Grant Subject to Other Tax Problems?

Yes. Both the Code section 422 rules applicable to “incentive stock options” (aka ISOs) and the Code section 162(m) rules applicable to its exemption for performance-based compensation condition their favorable tax treatment for stock options on their specification of an exercise price that is at or above fair market value. Because Misdated Options involve below-market exercise prices, they will disqualify ISO treatment, and cause the taxable income that arises at exercise (or settlement) to count against the annual \$1,000,000 deduction limit that applies to each NEO.

What is Meant By the Term “Misdated Grants”?

The term “backdating” is synonymous with fraud or misconduct, and that term is too narrow to suggest the 409A tax risk that Notice 2006-79 precipitates. Innocent defects in the process for granting stock options may trigger after-the-fact GAAP expense, and has already done so for many companies. A commonly-reported mistake involves a disconnection between the grant date for an award and the date on which the grant receives formal (proper) approval, e.g. through the

receipt of all committee signatures on a unanimous consent resolution. The term “Misdated Grants” is consequently intended to capture both backdated grants and those that are tainted by poor process.

Conclusion

The stock option backdating controversy has already prompted SEC investigations of over 100 public companies. On October 4th, the SEC’s former General Counsel David Becker put “in the current environment, every company” on notice to do at least an initial investigation into the grant dates of past stock

options.³ Given the potential for nightmarish 409A tax penalties, now would certainly seem to be the time to investigate past grants and to consider corrective alternatives – including tax mitigation strategies.

NOTES:

¹ Specifically: corporations that “as of the date of grant had issued any class of common equity securities required to be registered under Section 12 of the Securities Act of 1934.” Notice 2006-79, Section 4.07(A).

² Notice 2006-79, Section 4.07(C).

³ “Former SEC GC Becker: Every Company Should Review Stock Option Practices,” BNA Securities Law Daily, October 5, 2006.

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