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to: Area Counsel (Northeast Area)
(Tax Exempt & Government Entities)

from: Deputy Division Counsel/Deputy Associate Chief Counsel (Employee Benefits)
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subject: Application of Section 162(m) to Backdated and Misdated Stock Options

This Generic Legal Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

I. How is the date of grant of a stock option determined for purposes of § 162(m)?

II. Does a stock option whose exercise price was less than the fair market value of the stock at the date of grant ("discounted stock option") qualify as performance-based compensation under § 162(m)(4)(C) where the executive reimburses the employer for the excess of the fair market value on the date of grant over the exercise price or an agreement is entered into between the executive and the employer before exercise which provides for the exercise price to be increased to the fair market value of the stock on the grant date?

CONCLUSIONS

I. For purposes of § 162(m), the date of grant of a stock option is the date the granting corporation completes the corporate action constituting an offer of sale to an individual of a certain number of shares of stock at a fixed price per share. The grant dates LMSB examination used to compute adjustments, which are generally based on the measurement dates the taxpayers used for accounting purposes, are reasonable and appropriate dates under the present circumstances to use for purposes of applying § 162(m).

II. Discounted stock options are not qualified performance-based compensation under § 162(m)(4)(C) even if, before or after exercise, the executive reimburses the employer for the discount or the option is "repriced" based on the fair market value on the actual date of grant.

FACTS

In 2006, the IRS became aware of numerous instances in which stock options were granted with exercise prices less than the fair market value of the underlying stock on the date of grant. In many cases, the discount resulted from a discrepancy between the purported grant date and the actual grant date. The practice of backdating or misdating stock options raises several income tax issues, including whether the stock options are subject to § 409A, whether purported incentive stock options satisfy the requirements of § 422, and whether nonstatutory options meet the exception under § 162(m) for performance-based compensation. This memorandum addresses one element of the last of these issues – the appropriate standard for determining the date of grant for purposes of the exception for qualified performance-based compensation under § 162(m).

The following facts were developed by LMSB examination in several cases that are currently under examination. Stock options were granted to executives over several years under backdated or misdated grants, resulting in discounted stock options. The options at issue were generally granted before 2002, and in some cases were subject to vesting schedules.

In some of these cases, where the executive had already exercised the option, the employer attempted to "reprice" the option by obtaining a "voluntary" repayment from the executive in the amount of the option discount. Executives made such repayments both within and after the year of exercise. Where the executive had not yet exercised the option, the employer entered into a "voluntary" letter agreement with the executive under which the executive agreed to an increased share price based on the fair market value of the stock on the actual grant date. The option grant certificates and option grant agreements between the taxpayers and the executives were not canceled or amended to reflect increased exercise prices.

The taxpayers' corporate governance provisions and stock-based compensation plans, which had been approved by shareholders, specified the actions required to effect the grant of an option. As required under § 162(m), each taxpayer's board of directors appointed a committee of independent directors to oversee officer compensation ("compensation committee"), including stock-based compensation. Compensation committees had the authority to make decisions binding the corporation, including who would receive awards, the type of awards (e.g., stock options or stock appreciation rights), the number of shares granted, when an award is granted, and the rules regarding the administration of the plan. Compensation committees could delegate some of these duties to a member of management, but such delegation authority was limited to employees who were not officers under § 16 of the Securities Exchange Act of 1934.

Beginning in 2006, the SEC investigated many companies' past option-granting practices, and the companies appointed special committees to investigate past practices. Generally, the special committees concluded that favorable grant dates were chosen with the benefit of hindsight. In some cases, the special committees found that option grants were misdated because of administrative errors, often resulting from poor record-keeping, rather than intentional backdating. As a result of these investigations, many companies had to restate their earnings for financial accounting purposes because, under the accounting rules in effect when the options were granted, an expense was required to be recorded upon the grant of a discounted option.

The special committees in the present cases found that backdated or misdated options resulted from various practices. In some cases, management used "as of" grant dates, with granting documents sometimes drafted weeks or months after the purported grant date. Some companies maintained such poor records that it was impossible to determine the precise grant date. For example, companies did not prepare contemporaneous documentation of compensation committee meetings or unanimous written consent documents were prepared a substantial period of time after the purported grant. In some cases, lists of grant recipients and the number of shares were changed after the purported grant date. In other cases, the documentation maintained by companies in the form of compensation committee minutes, board of director meeting minutes, or unanimous written consent documents of the compensation committee established that options were incorrectly dated.

The Chief Accountant of the SEC issued a letter dated September 19, 2006 to officials at the American Institute of Certified Public Accountants discussing backdating/misdating practices, and advising companies on determining the grant date for financial accounting purposes.[1] Although the accounting standards are not controlling for federal tax purposes, the letter provides useful background on the practices that led to backdated or misdated options, and the standards companies used to determine grant dates for financial accounting purposes.[2] Generally, the letter notes, applicable laws and a company's corporate governance provisions and stock-based compensation plans set forth the corporate actions required to effect the grant of an option. The SEC staff found that, in some cases, option dates were set prior to the date that the required granting actions were completed. The SEC staff found that common practices which led to errors included companies' use of oral authorizations from the board of directors or compensation committee, rather than the date these actions were later documented; delegation of authority to grant options to a member or committee of

[1] Available at http://www.sec.gov/spotlight/optionsbackdating.htm.
[2] The letter correctly notes that the accounting standards are not controlling for federal income tax purposes.

management with later approval by the compensation committee; and failure to contemporaneously document a meeting or phone call of the compensation committee. The SEC expressed concern that these practices effectively leave open the possibility that grant terms could be changed, including the grant date, with the benefit of hindsight during the interim period until such time as all the required granting actions are completed and documented.

The SEC Chief Accountant's letter observed that the grant date for accounting purposes, termed the "measurement date", is the date when the individual recipient, the number of shares, and the option price are first known. As noted above, the special committees appointed by the taxpayers under examination by LMSB generally concluded that favorable grant dates were chosen with the benefit of hindsight and these investigations resulted in large financial statement restatements. LMSB has proposed adjustments assuming grant dates for § 162(m) purposes that are the same as the measurement dates the taxpayers used in their restatements in those cases where the taxpayers have been unable to provide documentation or otherwise establish the actual date upon which the stock options at issue were granted. For purposes of this memorandum, it is assumed that the restatements by taxpayers were consistent with the applicable accounting standards.

LAW AND ANALYSIS

Section 162(m)(1) provides that, for any publicly held corporation, no deduction is allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year exceeds $1 million.

Under § 162(m)(4)(C), applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of two or more outside directors; (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration; and (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

Section 1.162-27(e)(2)(i) provides that qualified performance based-compensation must be paid "solely on account of the attainment of one or more preestablished, objective performance goals." A performance goal is treated as preestablished under the general rule if it is established in writing not later than 90 days after the commencement of the period of service to which the goal relates, provided that the outcome is substantially uncertain at the time the goal is established and provided that the goal is not established after more than 25 percent of the performance period has elapsed. Section

1.162-27(e)(2)(iv) provides that determination of whether an amount is performance-based compensation is made on a “grant-by-grant” basis.

Under § 1.162-27(e)(2)(vi)(A), compensation attributable to a stock option is deemed to satisfy the performance goal requirement of § 1.62-27(e)(2) if the grant is made by the compensation committee; the plan under which the option is granted states the maximum number of shares with respect to which options may be granted during a specified period to any employee; and,

> [u]nder the terms of the option or right, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award. Conversely, if the amount of compensation the employee will receive under the grant or award is not based solely on an increase in the value of the stock after the date of the grant or award (e.g., in the case of…an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant is qualified performance-based compensation.

Section 1.162-27(e)(2)(vi)(B) provides that, if an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan.

The legislative history of section 162(m) discusses the circumstances under which stock-based compensation may qualify as performance-based compensation. The conference report provides:

> Stock-based compensation is not treated as performance-based if it is dependent on factors other than corporate performance. For example, if a stock option is granted to an executive with an exercise price that is less than the current fair market value of the stock at the time of grant, then the executive would have the right to receive compensation on the exercise of the option even if the stock price decreases or stays the same. Thus, stock options that are granted with an exercise price that is less than the fair market value of the stock at the time of grant do not meet the requirements for performance-based compensation. Similarly, if the executive is otherwise protected from decreases in the value of the stock (such as through repricing), the compensation is not performance-based.

H.R. Conf. Rep. No. 103-213, 675 (1993).

Analysis:

I. How is the date of grant of a stock option determined for purposes of § 162(m)?

Some taxpayers assert that some or all of the original grant dates were correct for § 162(m) purposes, even though they restated their financial statements because of incorrect grant dates. Taxpayers note that § 162(m) does not define "grant date," and suggest that it is appropriate to use a somewhat flexible standard, which in some cases may vary from the "measurement date" used for financial accounting purposes.

Standard for determining date of grant of a stock option for purposes of § 162(m)

Since the § 162(m) regulations do not provide a standard for determining the grant date, it is appropriate to look to the standards in similar rules under other provisions of the Code. For statutory stock options, § 1.421-1(c)(1) of the regulations provides:

> (c) Time and date of granting option. (1) For purposes of this section and §§ 1.421-2 through 1.424-1, the language 'the date of the granting of the option' and 'the time such option is granted,' and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable. Ordinarily, if the corporate action contemplates an immediate offer of stock for sale to an individual or to a class including such individual, or contemplates a particular date on which such offer is to be made, the time or date of the granting of the option is the time or date of such corporate action if the offer is to be made immediately, or the date contemplated as the date of the offer, as the case may be. However, an unreasonable delay in the giving of notice of such offer to the individual or to the class will be taken into account as indicating that the corporation contemplated that the offer was to be made at the subsequent date on which such notice is given.[3]

The § 409A regulations provide a similar standard. Section 1.409A-1(b)(5)(vi)(B)(1) of the regulations provides:

> The language the date of grant of the option, and similar phrases, refer to the date when the granting corporation completes the corporate action necessary to create the legally binding right constituting the option. A corporate action creating the legally binding right constituting the option is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider is designated.

The standard for determining the grant date in these regulations, which is based on the date the corporation completes the corporate action constituting an offer of sale of a certain number of shares of stock to a designated individual at a set price, is a

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[3] Although these regulations were amended in 2004, a substantially similar standard has been in place for many years. See T.D. 6887, 1966-2 C.B. 129 (under then existing § 1.421-7(c)(1), an option grant occurs when "when the corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option"). Similar to the current regulations, the prior regulations were interpreted to mean that a corporation completes the corporate action within the meaning of § 1.421-7(c)(1) when the number of shares of stock that may be purchased is fixed and determinable. Rev. Rul. 68-317, 1968-1 C.B. 186; Rev. Rul. 70-358, 1970-2 C.B. 96; Rev. Rul. 73-223, 1973-1 C.B. 206.

reasonable and appropriate standard for purposes of § 162(m). Moreover, application of this requirement in § 162(m) in a manner consistent with the application of the analogous requirements for statutory stock options and § 409A is particularly appropriate because of the similarity of the provisions. The statutory stock option rules and § 409A, like the § 162(m) regulations, provide more favorable tax treatment for compensatory stock options meeting certain requirements, one of which is that they be issued at a price at least equal to the fair market value of the stock on the grant date.

In order to ensure that stock options are in fact performance-based under § 162(m), the Service must have a verifiable way of determining the grant date. Basing the grant date on the date that certain corporate actions are completed and verifiable is an administrable standard for the Service and taxpayers. It is entirely within a company's control to ensure that the necessary steps to effect the grant of an option are completed and documented. For example, it is within a company's control to ensure that committee meeting minutes or unanimous written consent documents are prepared contemporaneously with or prior to the intended grant date. A less stringent standard would provide opportunity for manipulation, be more difficult to administer, and not provide certainty to taxpayers. Therefore, we conclude that, in the absence of guidance under § 162(m), taxpayers should apply the standard in the regulations and other published guidance under § 421 or the very similar standard under the § 409A regulations, and the Service should not challenge either standard.

Use of Alternative Standards

Taxpayers have argued for additional flexibility based upon the lack of an explicit standard for determining a grant date in the published guidance under § 162(m). Such flexibility is singularly inappropriate here. The taxpayers not only failed to abide by the longstanding standards for grant dates for statutory options, a closely analogous provision, but their "flexible" interpretations of the grant date resulted in substantial additional compensation to the executives that was not likely to have been contemplated by the shareholders approving the plan. This casts doubt on the validity of the shareholder approval of the plan, which is also a requirement for treatment as qualified performance-based compensation. *Cf. Ryan v. Gifford*, 918 A.2d 341, 351 (Del. Ch. 2007) (many state law corporate governance issues arise from option backdating, including the propriety of the executive compensation, whether the requisite disclosures relating to stock compensation have been met, and whether shareholder-approved plans have been complied with). Moreover, these taxpayers failed to comply with applicable accounting standards and may have violated state law duties. *See id*. Accordingly, the "flexible" approaches suggested by the taxpayers are not appropriate.

Use of Accounting Standards for These Cases

As noted above, the taxpayers applied Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25), in determining measurement dates for financial accounting purposes. APB 25 provides guidance for determining the measurement date (i.e., grant date) for grants made prior to 2002. LMSB examination generally used these dates in computing their proposed adjustments. Under APB 25, the measurement date is "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any."

In his September 19, 2006 letter, the Chief Accountant of the SEC advised:

> If a company operated as if the terms of its awards were not final prior to the completion of all required granting actions (such as by retracting awards or changing their terms), the staff believes the company should conclude that the measurement date for all of its awards (including those awards that were not changed) would be delayed until the completion of all required granting actions.
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> On the other hand, in certain instances where a company's facts, circumstances, and pattern of conduct evidence that the terms and recipients of a stock option award were determined with finality on an earlier date prior to the completion of all required granting actions, it may be appropriate to conclude that a measurement date under Opinion 25 occurred prior to the completion of these actions.

Thus, the SEC staff advised that completion of all required corporate granting actions is generally necessary for there to be a grant of stock options, but that a grant may occur at an earlier date depending on the facts and circumstances. Applying these standards, each corporation at issue here amended its financial statements.

The standards under the § 421 and § 409A regulations are more stringent than the accounting standards as described in the SEC staff letter, because the regulations require the completion of all required corporate granting actions. Nonetheless, although the accounting standards are not controlling for tax purposes, and are less stringent than existing tax standards, it is reasonable in the circumstances of these cases for LMSB to use the measurement dates determined by the taxpayers for purposes of their accounting restatements as the grant dates for purposes of § 162(m). The accounting standard is a reasonable standard that is not open to the type of abuse and manipulation to which an ad hoc standard, developed after the fact to rationalize what had been done, is vulnerable. Accordingly, given the lack of specific guidance under § 162(m) for determining the date of grant and administrative concerns, LMSB's use of the accounting standard is reasonable. Although in the present circumstances it is reasonable for LMSB to rely on the grant dates determined by the taxpayers for accounting purposes, in future cases the Service may insist on determining grant dates strictly in accordance with the standards under the current § 421 and § 409A regulations.

The option grants at issue may be divided into two groups. First, there were instances where options were simply backdated with the benefit of hindsight in order to increase the spread amount on exercise for the benefit of the recipient but sufficient documentation exists to establish the date that the corporate action was completed. In these cases, the redetermined grant dates were the dates when the corporation completed the corporate action required to effect the grant of a stock option. Such dates would generally have been the date the compensation committee approved the grant of the options, evidenced by an executed unanimous written consent document or committee minutes. These grant dates, as redetermined by the taxpayers for accounting purposes, are also the appropriate dates to use for § 162(m) purposes under these circumstances.

Second, there are cases where contemporaneous records that conclusively establish when the grant occurred are unavailable. In this context, it should be noted that deductions are strictly a matter of legislative grace and the taxpayer bears the burden of proving entitlement to the claimed deduction. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). In order to substantiate an expense, a taxpayer must establish each element required under the Code provision under which the taxpayer seeks a deduction. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) ("a taxpayer seeking a deduction must point to an applicable statute and show that he comes within its terms.").

Taxpayers are required to maintain adequate books and records in order to prove entitlement to deductions against income. Section 6001 requires that any person subject to tax, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, as are sufficient to establish the amount of gross income, deductions, credits, or other matter required to be shown by such person on any tax return. Even though a taxpayer may not be able to substantiate an expense, a court has the flexibility to estimate an expense where it is clear that the taxpayer incurred an expense. However, the court bears heavily against a taxpayer whose failure to maintain records is of his own making. *Cohan v. Commissioner*, 39 F.2d 540, 543-544 (2d Cir. 1930); *See also e.g., Cao v. Commissioner*, T.C. Memo (1994-60) ("While Cao's commission expenses may have been as great as he stated, his failure to keep adequate records must rest upon his shoulders alone.").

Section 162(m) and the regulations thereunder contain very specific requirements that must be met for compensation to qualify as performance-based compensation. One of the requirements is that the amount of compensation the employee could receive under an option must be based solely on an increase in the value of the stock after the date of grant or award. In the present cases, the taxpayers did not maintain adequate books and records from which the grant dates can be ascertained.

In such cases, the special audit committees used the best available evidence to determine the most likely grant dates, and these dates were used for accounting purposes. Absent other evidence produced by the taxpayers, the LMSB agents used the same grant dates for determining whether the compensation upon the exercise of the options was qualified performance-based compensation under § 162(m).

Under these circumstances, although the "measurement date" for accounting purposes is not controlling for tax purposes, and may be less stringent than the standards under the § 421 and 409A regulations, it is reasonable for LMSB to use the measurement dates used for accounting purposes as the grant dates for § 162(m) for purposes of processing the present cases.

II. Does a discounted stock option qualify as performance-based compensation under § 162(m)(4)(C) where the executive reimburses the employer for the excess of the fair market value on the date of grant over the exercise price or an agreement is entered into between the executive and the employer before exercise which provides for the exercise price to be increased to the fair market value of the stock on the grant date?

For most of the covered employees whose options are the subject of the examinations, the backdated or mispriced options had been exercised by the time the pricing errors were exposed. In some of these cases, employers attempted to "reprice" the options by obtaining "voluntary" reimbursements from the affected executives in the amount of the discount on the grant date. In some cases, where the options at issue had not yet been exercised, the corporation entered into "voluntary" letter agreements with the affected executives under which the executives agreed to increase the exercise price of the options based on the findings of the special audit committee. The option grants were not cancelled or amended in any of the cases.

Can an option be repriced after it has been exercised?

Some taxpayers assert that they should be permitted to "reprice" options, even after the executive exercised the option at the original discounted exercise price. Taxpayers assert that option repricing was permissible because the employer merely corrected a grant that conflicted with the terms of the stock-based compensation plan. Some taxpayers assert that any misdated options were legally invalid because the grant was inconsistent with the stock-based compensation plan, which prohibited the issuance of discounted options. Some taxpayers suggest that state law may have required reformation of the option grant. Taxpayers argue that mistakes in its plan administration were cured when it sought and obtained reimbursement from the executives to account for the difference between the original exercise price and the fair market value on the redetermined grant date.

Section 1.162-27(e)(2)(vi)(A) provides that the amount of compensation an employee may receive under a stock option must be based solely on an increase in the value of the stock after the date of grant. If the amount of compensation is not based solely on such increase (for example, because the option is granted with an exercise price that is less than the fair market value of the stock as of the grant date), none of the compensation under the option is qualified performance-based compensation. Whether a stock option satisfies the requirements of § 1.162-27(e)(2)(vi)(A) is determined as of the date of grant of the option. The regulations do not provide a mechanism to retroactively reprice an option in order to transform compensation resulting from the exercise of an option into performance-based compensation.[4] Because the compensation arising from the option grants was not based solely on an increase in the price of the stock after the grant date, as required by the regulations, none of the compensation attributable to the options was qualified performance-based compensation under § 162(m).

Further, where an option had been exercised before the backdating or misdating was discovered, the taxable transaction -- an offer and sale of a set number of shares at a set price -- was completed. Repayments by covered employees of discount amounts were separate transactions from the option grants for federal tax purposes, and therefore did not change the exercise price of the options.

Some taxpayers cite Rev. Rul. 79-311 (1979-2 C.B. 25) as support for their view that a transaction can be retroactively modified for federal tax purposes, including § 162(m). Rev. Rul. 79-311 dealt with an employee who repaid unearned advances upon termination, which he was legally obligated to repay pursuant to an express provision in his employment contract. Rev. Rul. 79-311 held that, generally, advances are income to the employees at the time of receipt. However, advances repaid in the year of receipt are excludable from the employee's gross income. By contrast, advances repaid in a year subsequent to the year received are not excluded from gross income for the year of receipt, but the employee may be entitled to a deduction in the year of repayment. Based on Rev. Rul. 79-311, taxpayers have argued that repayments within the year of exercise should result in the compensation being considered performance-based.

Rev. Rul. 79-311 is inapposite here for several reasons. First and foremost, Rev. Rul. 79-311 does not address the deductibility of compensation expenses under § 162, much less address the applicability of § 162(m) and whether stock-based compensation qualifies as performance-based compensation pursuant to § 162(m) and the regulations thereunder. Rev. Rul. 79-311 deals only with an individual's income tax treatment of the repayment of unearned advances. Neither the statute nor the regulations provide for any method that allows for correcting stock-based compensation granted to employees at less then fair market value on the date of grant.

In any event, the ruling is factually distinguishable from the present cases. First, in many of these cases, repayment was made in a year subsequent to the year of exercise. In addition, in contrast to the facts of the ruling, the stock price was fixed in the option grant, and the covered employees were not contractually required under the grant to repay any amount of stock appreciation to the employer. *Butchko v. Commissioner*, 638 F.2d 1214 (9th Cir. 1981), illustrates the significance of this

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[4] Section 1.162-27(e)(2)(vi)(B) provides that if, after issuance, the exercise price of an option is reduced, it is treated as if the option is cancelled and reissued. The regulation does not refer to increases in the price of an option; however, even if a similar rule were applicable in the case of an increase in the price, the option would at best be treated as canceled and re-issued. Accordingly, the option would not qualify as performance-based compensation if the exercise price of the option was less than the fair market value of the stock on the date of the deemed re-issue.

distinction. In *Butchko*, the taxpayer was a racetrack teller who was owed a daily wage under a collective bargaining agreement. In addition, the taxpayer was obligated under a separate agreement to repay any "shortages" in his accounts each day. The Ninth Circuit held that the taxpayer was required to include his wages in gross income, unreduced by the amount of the "shortages" he was required to pay to his employer. The court distinguished Rev. Rul. 79-311, noting that the ruling deals with advanced wages repaid to the employer pursuant to an express provision in the employment contract. By contrast, under the facts before the court, the contractually determined wages were never relinquished, and shortages were required to be paid to the employer under a separate agreement. Similarly here, the options were exercised pursuant to grants that stated a number of shares and a particular price, without any contingencies affecting these terms other than events such as capital structure changes. The option grant agreements did not call for repayment of remuneration under any circumstances. The option grants at issue were never cancelled and the taxpayers honored the option grants. The subsequent "voluntary" letter agreements to repay amounts of compensation did not affect the treatment of the compensation pursuant to the exercise of the option as gross income to the covered employee and did not retroactively transform the option into an option that satisfies the requirements for performance-based compensation.

In summary, whether a stock option is qualified performance-based compensation is determined at the time of grant. Subsequent actions such as a repayment by an employee cannot change the fact that the option was issued at a discount. Moreover, the grant and exercise of an option, and a later voluntary repayment of a compensatory amount, are separate transactions for federal tax purposes. Therefore, none of the compensation attributable to the discounted grants qualified as performance-based compensation under § 162(m).

Can an option be repriced before it has been exercised?

In some cases, employers "repriced" options before the options were exercised. In such cases, executives generally entered into voluntary letter agreements to increase the price of the shares. Again, whether a stock option satisfies the requirements of § 1.162-27(e)(2)(vi)(A) is determined as of the date of grant of the option. These actions to "reprice" the options did not change the fact that the options were issued at a discount, and the options at issue were never cancelled. [5]

Taxpayers have argued that whether an amount is deductible under § 162(m) should be based on the facts existing as of the last day of the taxable year for which the employer would claim the deduction, because it is not known until the last day of the taxable year whether an employee is a covered employee. Thus, the determination whether the

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[5] Moreover, even if the options had been cancelled and re-issued, the re-issued options would not satisfy the requirements for performance-based compensation if the exercise price was less than the fair market value on the date of the re-issue.

compensation is performance-based should not be made before the compensation is paid (when an option is exercised). Accordingly, provided the option is repriced before the date of exercise, the compensatory amount attributable to the option should qualify as performance-based compensation. This argument fails because the regulations specifically require that the determination whether compensation attributable to stock options is performance-based compensation be made at the time of grant, not at the time of exercise. Regs. § 1.162-27(e)(2)(vi)(A). Moreover, allowing an employer to "wait and see" whether it serves its tax objectives to increase the price of an option at any point up to the time of exercise would frustrate the purpose of the statute, which was to align the performance incentive with the interests of shareholders.

In addition, some taxpayers maintain that the regulations suggest that an employer has the discretion to reduce performance-based compensation, including compensation from option grants. These taxpayers cite, for example, § 1.162-27(e)(2)(vii) (ex.1), which provides that a bonus qualifying as performance-based compensation may be reduced based on subjective factors and still qualify as performance-based compensation. The taxpayers argue by analogy that they should be permitted to increase an option price before exercise in order to qualify the option as performance-based compensation. This argument fails, again, because there are special rules for stock-based compensation that must be met. These rules do not permit option price increases after the date of grant, but instead require that the qualification determination be made based on the facts on the date of the grant. Regs. § 1.162-27(e)(2)(vi)(A). Moreover, the examples cited in the regulations involve situations where the compensation was performance-based at the time of the award, and then later reduced. Here, the stock-based compensation never qualified as performance-based compensation.

Taxpayers have suggested that the Service's treatment of the backdated option issue under § 162(m) is inconsistent with its treatment of the issue under §§ 422 and 409A. The Service has taken a consistent approach with respect to backdated stock options under these other provisions. Section 422 provides certain tax advantages for an incentive stock option (ISO), provided that the exercise price of the option is not less than the fair market value of the underlying stock on the grant date. The Service has treated backdated options that were intended to qualify as ISO's under § 422 as nonstatutory options subject to the rules of § 83. Taxpayers were required to recognize income (the difference between the exercise price and the fair market value of the shares on date of exercise) on the date of exercise. The Service has not permitted employers to reprice options in order to retroactively meet the requirements of § 422.[6]

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[6] See June 15, 2007 Memorandum for Industry Directors; Director, Prefiling and Technical Guidance; Director, International Compliance Strategy and Policy from Walter Harris Director, Field Specialists, available at: http://www.irs.gov/businesses/article/0,,id=17164,00.html.

A similar issue arises under § 409A, because a discounted stock option is nonqualified deferred compensation subject to the requirements of § 409A. Section § 885(f) of the American Jobs Creation Act (P.L. 108-357) required Treasury and the Service to provide transition relief for a limited period to permit amendments to existing nonqualified deferred compensation plans to (i) allow a participant to terminate participation in the plan, or cancel an outstanding deferral election with respect to amounts deferred after December 31, 2004, or (ii) conform the plan to the provisions of § 409A with respect to amounts deferred after December 31, 2004. Notice 2005-1 (2005-1 C.B. 274) provided that any discounted option could be cancelled and reissued assuming the original grant date until December 31, 2005 in order to comply with § 409A.

Notice 2005-1, the preamble to the 2005 proposed regulations (70 FR 57930, 57956), and Notices 2006-79 (2006-2 C.B. 763) and 2007-86 (2007-46 I.R.B. 990) provided certain transition relief for nonqualified deferred compensation arrangements, including discounted options. The preamble to the 2005 proposed regulations generally extended this period in which cancellation and reissuance was permitted to December 31, 2006, and Notices 2006-79 and 2007-86 extended the period to December 31, 2007 and December 31, 2008, respectively. This transition relief was necessary because unexercised options issued at a discount before the enactment of § 409A would have been automatically subject to § 409A. Moreover, § 409A was a new and complex statute, and final regulations had not become effective, and therefore it was appropriate to provide transition relief. By contrast, § 162(m) and the regulations thereunder have been in place for many years.

Notably, Notices 2006-79 and 2007-86 did not provide relief for options that were granted to persons who were subject to the disclosure requirements of § 16(a) of the Securities Exchange Act. Thus, after the Service became aware of the backdating issue, Notices 2006-79 and 2007-89 excluded insiders, including covered employees, from the transition relief. In addition, Notice 2008-113 (2008-51 I.R.B. 1305), which provides certain relief under § 409A for discounted options that were repriced, is a voluntary correction program that provides a limited opportunity to correct solely for purposes of section 409A. It has no application to § 162(m). (Moreover, even for purposes of § 409A, the repricing by the taxpayers at issue here would not have complied with the time limits provided in Notice 2008-113).

In summary, whether a stock option is qualified performance-based compensation is determined at the time of grant. Subsequent actions intended to retroactively reprice an option cannot change the fact that the option was issued at a discount. Remuneration resulting from the exercise of discounted stock options that were “repriced” before exercise is not qualified performance-based compensation under § 162(m)(4)(C).

Please call (202) 622-6030 if you have any further questions.

/s/

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