

employee benefits lawflash

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Court Affirms Discounted Stock Options Are Deferred Compensation Subject to Section 409A

Court of Federal Claims agrees with the IRS position that section 409A applies to discounted stock options; holding is important for compensatory stock option grants.

On February 27, the U.S. Court of Federal Claims ruled in *Sutardja v. United States*,¹ finding that section 409A of the Internal Revenue Code applies to discounted stock options, with the potential adverse tax consequences that the entire appreciation in the option position is subject to the 20% penalty tax under section 409A in addition to ordinary income tax and that this tax would be payable on option vesting rather than on exercise.

Background

Section 409A of the Internal Revenue Code provides a comprehensive set of rules regulating the taxation of nonqualified deferred compensation. Section 409A does not explicitly define “deferral of compensation,” but, throughout Internal Revenue Service (IRS) notices, proposed regulations, and the final Treasury Regulations, the IRS has been consistent in its position that discounted stock options are deferred compensation subject to section 409A. Most notably, IRS Notice 2005-1 states that, if a stock option is granted with a per share exercise price that is less than the fair market value of the underlying stock on the date of the grant, the option will be treated as a deferral of compensation and will fall under the parameters of section 409A.²

Sutardja Decision

In *Sutardja*, the Court of Federal Claims affirmed the IRS’s position that Section 409A applies to discounted stock options. The case arose after the IRS determined that the plaintiff’s exercise of stock options was subject to an additional 20% tax under section 409A. The plaintiff was the president, chief executive officer, and chairman of the board of directors of a technology company whose stock is traded on the NASDAQ stock exchange. The plaintiff exercised his stock options in 2006, during a transition period between the effective date of section 409A and the effective date of the applicable regulations.

The plaintiff argued that the definition of “deferrals of compensation” under Notice 2005-1 was contrary to U.S. Supreme Court jurisprudence. Specifically, in the seminal case of *Commissioner v. Smith*,³ the Supreme Court established the principle that the mere grant of employee stock options is not a taxable event. In that case, the Supreme Court analyzed an option to purchase stock “at a price not less than the then value of the stock”⁴ (i.e., a nondiscounted option) and found that there was no compensation until exercise. Since Notice 2005-1 preserves the same treatment for nondiscounted options by excluding them from the definition of “deferred compensation,” the Court of Federal Claims found that the Notice was, in fact, consistent with Supreme Court jurisprudence.

1. *Sutardja v. United States*, No. 11-724T (Fed. Cl. Feb. 27, 2013), available at <http://www.uscfc.uscourts.gov/sites/default/files/WHEELER.SUTARDJA022713.pdf>.

2. View Notice 2005-1 at http://www.irs.gov/irb/2005-02_IRB/ar13.html.

3. *Comm’r v. Smith*, 324 U.S. 177 (1945).

4. *Id.*

The plaintiff also argued that, in determining what constitutes a “deferral of compensation,” the court should look to the definition contained in the Federal Insurance Contributions Act (FICA) regulations,⁵ which includes a definition substantially similar to the definition in Notice 2005-1. The FICA regulations, however, specifically exclude the grant of a stock option from the definition “for purposes of Section 3121(v)(2).” The Court of Federal Claims held that the FICA regulations do not apply for purposes of defining “deferred compensation” under section 409A because the definition under the FICA regulations is limited to the section 3121(v)(2) context.

Finally, the plaintiff argued that, even if the option was granted at a discount and subject to section 409A, any deferral of income would fall within the short-term deferral exception because he exercised the fully vested portions of the option in January 2006 and therefore did not defer his compensation for a period greater than two and a half months after the year in which the portions of the option vested. The court disagreed, stating that the stock option plan under which the plaintiff’s option was granted allowed for a vested option to be exercised within 10 years from the grant date, thus exceeding the two-and-a-half-month short-term deferral period. (This conclusion conforms to the IRS’s position as stated in Chief Counsel Advice 200728042,⁶ which had been somewhat controversial because a number of taxpayers believed that this conclusion was not clearly required by Notice 2005-1.)

The court also held that section 409A enacted a statutory change that results in the treatment of discounted stock options as deferred compensation for purposes of section 409A. However, the plaintiff has not yet lost his case because the court concluded that a genuine issue of material fact existed as to whether the stock option was discounted at the time it was granted. The matter will be set for trial, and, given the facts and circumstances of the stock option grant, there still remains the possibility the plaintiff will prevail.

Implications

This decision underscores the importance of careful attention by issuers of stock options to determining and documenting the fair market value strike price of options so as to withstand review on audit. The regulations under section 409A provide procedures for determining fair market value for these purposes, and there are advantages and disadvantages to the alternatives provided. In the event that the issuer wants to issue a stock right to a service provider with a built-in discount, a number of methods of accomplishing this goal are available. However, this decision serves as a good reminder that discounted stock options or discounted stock appreciation rights must be treated as deferred compensation subject to section 409A payment timing restrictions and must be properly documented to be compliant with section 409A from the date of the grant, or profoundly negative section 409A tax consequences will apply.

Further, future developments in this case (addressing the factual and legal issues relating to the determination of the grant date) also merit watching, because the Court of Federal Claims is expected to address in its next decision issues relating to (i) the compensation committee’s authority to make grants; (ii) the effect of ratification of prior grants; and (iii) the special “good faith” exception, which protects taxpayers from the assessment of any taxes under section 409A if any option granted before 2005 had been granted in compliance with the incentive stock option regulations and the parties to the option agreement believed in good faith that the option was not discounted.⁷

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5. Treas. Reg. § 31.3121(v)(2).

6. View Chief Counsel Advice 200728042 at <http://www.irs.gov/pub/irs-wd/0728042.pdf>.

7. See Notice 2006-4, 2006-3 I.R.B. 307.

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