The Options Aren't Looking as Good

By Edward M. Robbins, Jr and Steven Toscher

Edward Robbins and Steven Toscher take a look at whether the recent involvement of the IRS Criminal Investigation Division in the stock option backdating investigation makes sense and discuss what criminal tax violations prosecutors may ask the grand jury to charge.

Background

On July 13, 2006, the U.S. Attorney for the Northern District of California, Kevin V. Ryan, announced the formation of a local stock options backdating task force that is charged with investigating allegations of companies and individuals in Northern California who retroactively changed the grant dates of stock options with the intent to defraud. The task force is investigating several Bay Area companies to determine the extent of the intent to mislead or defraud shareholders in the dating and awarding of stock option grants. At that time, the task force included members of the U.S. Attorney's Office and the FBI in the Northern District of California.

On September 7, 2006, Ryan upped the ante by announcing that IRS-Criminal Investigation would join the local stock options backdating task force. Ryan explained, "We will investigate whether individuals and companies may have deliberately backdated stock options with the intent to defraud. It is integral to the public trust in our financial markets that books and records are maintained honestly, and that the true financial condition of public companies is disclosed accurately. Falsification or backdating of financial documents may call the integrity of companies' financial statements into question, can constitute fraud on the company, shareholders, and the market, and may give rise to tax violations. We will evaluate the facts of each case, and we will bring criminal charges when appropriate." IRS Criminal Investigation Special Agent in Charge, Roger L. Wirth, added,

> IRS Criminal Investigation is proud to bring our financial investigative expertise to the table in this effort to stop securities fraud and related white collar crime. With the recent discoveries of significant fraudulent misconduct in connection with backdating of stock options, IRS-CI will work to help ensure both the companies and executives involved in such illegal activity are in compliance with the tax laws and where we can assist our law enforcement partners and the U. S. Attorneys Office in enforcing the money laundering statutes. This task force is another example where by combining our resources together as a law enforcement community, we can have the greatest impact in stopping these criminal activities and hold the perpetrators accountable for their illegal actions.

What to Expect from the IRS Criminal Investigation Entry into the Options Backdating Investigation

The IRS is charged with enforcing the nation's tax laws. To achieve its goal of encouraging voluntary compliance, the IRS conducts civil audits and criminal investigations. In a civil audit, the IRS focuses its efforts on determining whether a taxpayer correctly reported taxes to the federal government. If the IRS determines that the taxpayer did not report the correct amount of

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tax, the IRS can propose tax deficiencies, and, if upheld or uncontested, may assess additional taxes, interest and a variety of penalties. The IRS has the power to place a lien or levy on the taxpayer's property with respect to any unpaid taxes. In a criminal investigation, however, the IRS focuses on whether the taxpayer knowingly and intentionally violated the tax laws. Here, the IRS Criminal Investigation (IRS-CI) will be running its investigation as part the grand jury investigation conducted and controlled by the U.S. Attorney's Office. IRS-CI will, in effect, use the power of the grand jury to develop the facts on any criminal tax case under investigation. The most common types of tax charges include attempted evasion of federal income tax[1] and charges relating to filing false tax returns or making fraudulent statements to the IRS, including aiding and abetting such conduct,[2] and less often, willful failure to file or to pay federal income tax,[3] or attempted interference with the administration of the tax laws.[4] Conspiracy and false statement charges from Title 18 (§§371, 1001) are frequently used in conjunction with Title 26 offenses when the object of the conspiracy or false statement is tax fraud. In addition to these federal tax crimes, IRS-CI investigates related financial crimes, including violations of the Bank Secrecy Act and the Money Laundering Control Act.

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A cursory look at the tax issues inherent in the options backdating investigation may suggest to some that the issues are "too technical" to support criminal tax charges. This is a similar conclusion reached by many tax professionals who initially analyzed the tax shelters a few years ago. Obviously those predictions concerning the criminal potential in the tax shelters were wrong. Leading the headlines recently has been the indictment of tax professionals in connection with promoting aggressive tax shelters and related obstruction of justice allegations.[5]

With the introduction of IRS-CI into the stock options backdating task force, it is reasonable to conclude that the U.S. Attorney and IRS-CI do not think the issues are "too technical." We can expect that IRS-CI will identify a promising handful of companies and individuals and investigate them in excruciating detail. In the murky and subjective world of criminal tax investigations, IRS-CI criminal investigators focus on two elements: (1) a solid and substantial tax deficiency and (2) so-called "badges of fraud," that is, sneaky behavior by the taxpayer that circumstantially demonstrates a guilty mind. The question is whether stock options backdating efficiently serves up both elements. The discussion below attempts to divine what IRS-CI might ultimately ask the grand jury to charge.

How Stock Options Are Supposed to Work

Stock options give recipients the right to buy company stock at a set price called the exercise price or strike price. Most option plans require that the exercise price be equal to the stock's closing price on the date of the grant. Options generally vest (can be exercised) sometime after the grant date and expire several years from the grant date. If a company's stock price increases above the exercise price, options are considered "in-the-money." If a company's stock decreases below the exercise price, options are considered "out-of-the-money." Consumers can buy stock options from their broker. Companies can give stock options to officers, directors and other employees as part of their compensation.

How Stock Options Are Granted at the Company Level

Company stock option plans determine how many option shares may be granted to officers, directors and other employees. Stock option plans are approved by shareholder vote. After a stock option plan is approved, the company's board of directors or a compensation committee approves individual stock option grants. The compensation committee is responsible for making sure that the options awarded are fair to the company's shareholders and do not constitute an unfair "windfall" to the executive who receives them.

For example, in accordance with a company's written stock option plan, and as specifically authorized by the company's board of directors or a duly authorized committee of the board, the company grants an officer an option to purchase company stock in the future at an exercise price of $10 per share, when the company's stock price on the grant date is $10

per share. The executive is "at-the-money" with this $10-per-share option.

Properly utilized, stock options motivate management to improve a company's financial performance and lift its stock price in a manner that also benefits public shareholders. However, when a public investor buys company stock, the investor is necessarily at risk. Option grants should put the executive at risk as well; that is, if the company's stock price rises, the executive benefits, but if the stock price does not rise, or if the price falls, the executive suffers a fate similar to that of public shareholders—although the executive does not lose actual investment dollars, at least there is loss of the opportunity to gain from the stock's appreciation.

Stock Options Backdating

In its simplest form, the company grants an officer an option to purchase company stock in the future at an exercise price of $10 per share calculated from the stock's price at an earlier date, where the company's actual stock price on the grant date is $20 per share. The executive is "in-the-money" with this $10 per share option on the grant date. Thus, backdating involves establishing a grant date in hindsight with knowledge that the stock price has in fact already increased from the grant date price, that is, a built-in gain.

It is important to understand that there is nothing inherently unlawful about this sort of options backdating. If the company's plan allows backdating, if the board authorizes the backdating, if the company wants to forgo favorable tax treatment (see discussion below) and if the paperwork is contemporaneous and reflects accurately what occurred, the conduct is innocent. However, ordinarily, the company's plan provides for "at-the-money" options because the company wants the accounting and tax treatment that comes with "at-the-money" options.

There are also a host of innocent timing problems that can occur to create backdating where the company's plan provides for "at-the-money" options. The company might honestly intend to establish a contemporaneous grant date, but fail to obtain or finalize the necessary formalities on a timely basis. Some timing problems could be more questionable, such as granting new employees options before they are hired or having the board create an options pool with the grants later given to specific employees by an unauthorized officer. IRS-CI should not concern itself with these innocent or even questionable timing problems. IRS-CI should concern itself with the egregious timing problems.

The Federal Tax Consequences of Stock Options Granted by a Company

Backdating creates potential federal tax problems for the company and the employee/optionee in three primary areas: (1) failure for such options to qualify under the rules governing incentive stock options (ISOs), (2) exceeding the compensation deduction limits of Code Sec. 162(m) and (3) violations of Code Sec. 409A.

Incentive Stock Options

Incentive Stock Options, or ISOs, have favorable tax treatment for the employee. Neither the grant nor exercise of an ISO creates compensation income to the employee for income and payroll tax withholding purposes.[6] Income arising from the exercise of an ISO is not subject to FITW, FICA or FUTA.[7] Consequently, in both situations, the company is not entitled to claim a compensation deduction. Rather, the employee recognizes capital gain or loss when the stock acquired through exercise of the option is disposed of.[8] When an employee disposes of ISO stock after completion of the statutory holding period (*i.e.*, after the stock has been held more than two years after the date the option was granted and more than one year after the date the option was exercised), the employee will be required to recognize the difference between the amount received in such disposition over the employee's basis in the ISO stock as capital gain.

For a stock option to qualify as an ISO under the Code, it must meet certain requirements when it is granted,[9] and certain requirements during the period the option is held by the optionee until the option is exercised by the optionee.[10] In addition, certain special rules apply in determining the fair market value of the stock subject to the ISO in the case of changes to the ISO after it has been granted, in the case of a substitution or assumption of an ISO and to ISOs granted to a 10-percent owner. ISOs also carry a dollar limitation. Options are not treated as ISOs (but are instead treated as nonstatutory stock options, see below), to the extent that the aggregate fair market value of stock with respect to which ISOs are

exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000.

However, ISOs are required to be granted "at-the-money." Therefore, a backdated option that has been granted at a discount would violate one of the requirements that apply to ISOs. If the requirements for an ISO have not been followed, the option will be treated under the tax rules as a Nonstatutory Stock Option (NSO). The taxation of NSOs is governed by Code Sec. 83.

Nonstatutory Stock Options

Unlike ISOs, which are not subject to income tax upon exercise, but only upon sale of the stock (except for the possible imposition of alternative minimum tax on the option spread at exercise),[11] NSOs (including options that have failed to meet the requirements for ISOs) are subject to income tax and FICA withholding upon exercise. The difference between the exercise price and the sales price would be additional wages to the executive, which must be included on the employee's Form W-2 in the year of exercise. As a result, a company that granted backdated options that it believed were ISOs, would ordinarily not have withheld income tax or FICA upon exercise of the option. In that case, the company would be liable for the amount of the income tax and FICA that the company failed to withhold upon the exercise of the "in-the-money" option that failed to meet the ISO requirements, in addition to interest and potential penalties. Furthermore, any individual at the company who knowingly failed to withhold or pay income tax or FICA could be subject to personal liability for any such failure.[12] Depending on the number of affected options and the degree to which those options have been exercised, the liability for underpayment of employee withholding taxes could be substantial.

Thus, with backdated options, the employee will lose the deferral and capital gain rate benefits associated with ISO qualification, but the company may be eligible for an additional wage deduction if Code Sec. 162(m) limitations are not triggered and other requirements are met. Thus, some of the corporations that engaged in backdating may be entitled to additional deductions and may be entitled to refunds as a result of the backdating of the ISOs—hardly sounds like someone was committing a tax crime—but read on.

$1 Million Cap on Executive Compensation under Code Sec. 162(m)

Under Code Sec. 162(m), a publicly held corporation's deduction for compensation paid to its chief executive officer, or to one of its next four highest-compensated officers, is limited to $1 million per year, except for payments that qualify as commissions or as "performance-based" compensation.

Ordinarily, stock options with an exercise price that is "at-the-money" will qualify as "performance-based" compensation under Code Sec. 162(m) that does not have to be taken into account in calculating whether an executive's compensation has exceeded the $1 million compensation cap (assuming that the other requirements of 162(m) have been satisfied).

If a stock option has been backdated, however, and as a result was granted "in-the-money," all of the income resulting from the exercise of the option (including the income recognized by the executive upon the exercise of a noncompliant incentive stock option) must be included for purposes of calculating whether the executive's compensation exceeded the $1 million cap under Code Sec. 162(m).

Consequently, a company that mistakenly believed that the stock option qualified for the performance-based exception under Code Sec. 162(m) may have deducted compensation paid to an executive in excess of $1 million, in violation of Code Sec. 162(m). In this case, the company may have to amend its income tax returns and could be subject to interest and penalties for any additional income tax it owes.

Code Sec. 409A

Code Sec. 409A, which was adopted as part of the American Jobs Creation Act of 2004,[13] enacted a major overhaul to the tax treatment of deferred compensation, including discount stock options (*i.e.*, stock options with in-the-money exercise prices at their date of grant). Stock options that have been backdated to be "in-the-money" will generally run afoul of Code Sec. 409A to the extent they were (1) granted after October 3, 2004, (2) granted before October 4, 2004, but not vested as of December 31, 2004, or (3) materially modified after October 3, 2004.

Under Code Sec. 409A, the optionee may now be responsible for the payment of tax on income previously deferred until the exercise of the options. In

addition, there can be substantial additional taxes under Code Sec. 409A. Amounts deferred under the option for the current tax year, and all preceding tax years, are includible in the optionee's gross income, to the extent not subject to a substantial risk of forfeiture and not previously included in income.[14] These deferrals are also subject to an additional tax equal to 20 percent of the compensation required to be included in gross income. The tax due is increased by interest at the underpayment rate,[15] plus one percent per annum from the year in which the amount was first deferred or no longer subject to a substantial risk of forfeiture, if later, to the year in which it is included in income.[16]

A worst case scenario under Code Sec. 409A for the optionee would have the optionee picking up ordinary income equal to the option spread at the grant date and paying the resulting income tax, plus a penalty equal to 20 percent of the tax, plus interest, at a rate one percent per annum above the usual statutory interest in the event of a late payment.

We are currently in a transition period with the rules relating to Code Sec. 409A. During the transition, options that were in the money on the grant date can be amended to avoid violating Code Sec. 409A in either of two ways. The parties can increase the exercise price to equal the fair market value on the actual grant date and eliminate any other deferral feature, or the parties can amend the options to provide for a fixed exercise date after which the option will be worthless. Alternatively, the grant of backdated options could be rescinded if the options have not been exercised. Since Code Sec. 409A problems are probably curable, we do not anticipate any criminal tax cases involving Code Sec. 409A.

The Criminal Tax Case: The Egregious Case of Stock Options Backdating

The ideal criminal tax case arising from options backdating would include elements of personal gain to the defendant, coupled with falsification of company books and records and other misleading conduct. Recall that IRS-CI criminal investigators focus on two elements: (1) a solid and substantial tax deficiency and (2) so-called "badges of fraud," that is, sneaky behavior by the taxpayer that circumstantially demonstrates a guilty mind. The criminal tax case might look something like this variation of our earlier hypothetical: The defendant, an officer and board member, falsifies paperwork showing that the company granted the defendant an ISO to purchase company stock in the future at an exercise price of $10 per share, calculated from the stock's price at an earlier date of more than one year, when, in fact, the company's stock price on the actual grant date is $20 per share. The defendant is "in-the-money" with this $10-per-share option on the grant date. The defendant's false paperwork looks like it was all created at the earlier date, thus concealing the fact of the backdating, and concealing the fact that the option no longer qualifies as an ISO. Defendant exercises the option (and pays no tax) and holds the stock for one year, before selling it at a long-term capital gain.

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Here, the underpayment occurs on the defendant's individual income tax return when the defendant exercised the option and failed to pick up the ordinary income resulting from the exercise of an NSO. The tax deficiency looks fairly solid and substantial, *viz.*, the defendant was required to pick up ordinary income on the exercise of the option, and he did not. The provable sneaky behavior—at least relating to the backdating—seems to be here in that the defendant manufactured all sorts of false paperwork to memorialize transactions that never occurred.

But did the defendant know the tax return was wrong, and is it clear enough to suggest a criminal tax case? If the defendant has manipulated the grant date to not only pick a low strike price, but also to falsely extend the holding period so that he or she may report long term capital gain, its starting to look like the "violation of a known legal duty" relating to the defendant's tax return—but were the tax issues even considered by the executive?

Another possibility, also difficult for the government to prove, would be: Defendants knowingly cause the company to take compensation deductions in excess of the $1 million cap on executive compensation under Code

Sec. 162(m) as the result of the options backdating. Here, the underpayment occurs on the company's income tax return because of the improper deductions. This charge is more problematic—were any of the people involved in the backdating even aware of the tax consequences and the obscure Code Sec. 162(m)?

This raises difficult issues of the type of intent necessary to commit a tax crime, including the doctrine of "collective intent" when dealing with corporate wrongdoing. The law is clear that stealing from a corporation by an employee (which backdating could be considered) does not necessarily make the corporate tax return intentionally false or the wrongdoer responsible for the false corporate tax return. There must be a closer connection between the falsity and intent regarding the tax return and taxes. It is not enough that the defendant's purposeful conduct merely resulted in the filing of a false return; the false filing must also have been a deliberate objective of the defendant.[17]

Stated another way, it will not be sufficient for the government to prove that the defendant engaged in systematic backdating of stock options that had the consequence of causing a tax deficiency for the company. The government must also prove that the defendant had those tax consequences in mind in order to secure a conviction for a tax crime.

There exists in the backdating cases, however, a feature that greatly helps the government prosecute a criminal tax violation despite the "technical" difficulties. These options backdating tax prosecutions will likely be "add-on" tax counts (unlike the tax shelter prosecutions, for example). That is, the tax charges will be added to the end of the indictment following the major counts relating to securities fraud. One of the strongest badges of fraud the government can have is other (nontax) illegal conduct. Thus, if the securities fraud is proven, the options backdating tax charges will be that much easier for the government to prove.

Conclusion

IRS-CI's involvement in the investigation of technical tax transactions harkens back to the theme of the *Star Trek* series—"Boldly going where no man has gone before." Like *Star Trek*, IRS-CI will encounter things they have not encountered before. In one sense, the government will have a difficult burden to establish criminal tax violations in technical areas of taxation, where it takes specialized practitioners a long time just to figure it out, and when they do figure it out, do not agree. It is hard to make a criminal tax case if that is what we are talking about. On the other hand, the Chief of the IRS Criminal Investigation Division, Nancy Jardini, had it right when she indicated that IRS-CI would be taking a look at even the most technical transactions because when it comes to criminal tax fraud, "it's all about the lies. . ." Stay tuned.

Endnotes

1 Code Sec. 7201.
2 Code Sec. 7206.
3 Code Secs. 7202 and 7203.
4 Code Sec. 7212.
5 *See* Superseding Indictment, *United States v. Stein*, Case No. S1 05 Cr. 888 (LAK) (S.D.N.Y Oct. 1 , 2005) referred to as "the KPMG case".
6 Code Sec. 421(a).
7 Code Secs. 3121(a)(22) and 3306(b)(19).
8 Code Sec. 422(a)(1).
9 Reg. §1.422-1.
10 Reg. §1.422-1.
11 The exercise of an ISO does create an alternative minimum tax item, which is beyond the scope of this article.
12 Code Sec. 6672.
13 American Jobs Creation Act of 2004 (P.L. 108-357).
14 Code Sec. 409A(a)(1)(A).
15 Code Sec. 409A(a)(1)(B)(ii).
16 Code Sec. 409A(a)(1)(B), 409A(b)(4)(B).
17 *See A. Searan*, CA-6, 259 F3d 434, 444-45 (2001) (affirming Code Sec. 7206(2) convictions, where defendant actively participated in scheme and knew that returns filed contained false statements of material fact); *J. Aracri*, CA-2, 968 F2d 1512, 1523 (1992) (government presented sufficient evidence for jury to find that defendants intended that fuel companies file false gasoline excise tax returns); *L.J. Salerno*, CA-9, 90-1 USTC ¶50,261, 902 F2d 1429 (convictions reversed because government failed to show that casino employee knew or understood that his embezzlement scheme would affect preparation of the casino corporate returns); *cf. S.Z. Gurary*, 88-2 USTC ¶9573, 860 F2d 521 (government presented sufficient evidence to show that defendants, who sold fraudulent purchase invoices to corporations, knew their scheme would result in corporations using the fraudulent invoices in the preparation of the tax returns).