



Options on the Margin—A Taxpayer's Experience with Nonqualified Options  
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## Why a Margin Loan Doesn't Make A Stock Into an Option...

In this week's podcast, we look at the recent case of *Racine v. Commissioner*, TC Memo 2006-162, which dealt with a taxpayer who faced a problem many taxpayers did in 2000. Gail Racine exercised stock options and elected to hold onto the shares, only to see the value of the shares plummet. In Gail's case, she exercised the options by using option loans from a broker secured by her shares.

Gail attempted to argue that the original spread should not be taxable to her, but rather only the amount she realized when the shares were ultimately sold to offset the margin loans, relying on a sentence in Reg. §1.83-3(a)(2) that allows treating certain shares exercised subject to a nonrecourse loan as being equivalent to the issuance of a new option rather than the actual exercise of the first option. The IRS argued this sentence did

not apply to Gail's situation, since in her case the resulting shares were not essentially equivalent to an option, but rather were simply margined shares like any other.

The Tax Court agreed with the IRS, but did not impose penalties on Gail, finding that she reasonably relied on the advice of a tax attorney for the position she took.

## Encumbered Shares that Are "Like" an Option

When nonstatutory options are received, if they do not have a readily ascertainable fair market value (as most don't), then taxation is delayed until the options are exercised by the employee (Reg. §1.83-7(a)). At that point, the general rules of §83 come into play, and the employee is taxed on the difference between the fair value of the shares received and the exercise price. So a key point becomes tying down the date on which the options were exercised, since that triggers both the taxation and the measurement of the amount to be taxed.

The major issue in this case was the interpretation of a provision in Reg. §1.83-3(b)—specifically the sentence that notes "In addition, if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of such indebtedness, such transaction may be in substance the same as the grant of an option." The regulation goes on to note that the substance of the transaction would be determined by all of the facts and circumstances applicable to the transaction.

Ms. Racine also noted Reg. §1.83-3(a)(7), Example 2 to buttress her position. That reads:

*Example 2.* On November 17, 1972, W sells to E 100 shares of stock in W corporation with a fair market value of \$10,000 in exchange for a \$10,000 note without personal liability. The note requires E to make yearly payments of \$2,000 commencing in 1973. E collects the dividends, votes the stock and pays the interest on the note. However, he makes no payments toward the face amount of the note. Because E has no personal liability on the note, and since E is making no payments towards the face amount of the note, the likelihood of E paying the full purchase price is in substantial doubt. As a result E has not incurred the risks of a beneficial owner that the value of the stock will decline. Therefore, no transfer of the stock has occurred on November 17, 1972, but an option to purchase the stock has been granted to E.

Note that in the example, the loan was from the employer to the employee and the example comes to the finding that, in this case, the employee was not the beneficial owner of the shares—rather, the employee was still basically in the same position as one holding an option to purchase shares.

## Racine Facts

Gail Racine had options to acquire shares in her employer, which she exercised in 2000 as follows:

Purchase date	Shares purchased	Exercise price	Tax withholding	Market value of shares
Mar. 9, 2000	20,210	\$45,579.66	\$584,496.16	\$1,695,113.75
Apr. 12, 2000	2,524	6,616.39	53,524.27	151,124.50
Aug. 7, 2000	2,523	6,614.75	45,536.28	126,465.38

She borrowed funds from CIBC Oppenheimer, a brokerage firm that was affiliated with her employer, to exercise the options and pay the withholding taxes. She then held onto the shares.

The price of the shares began to decline dramatically later in the year, and the majority of her shares were sold before the end of 2000 in answer to margin calls.

On their original return, Mr. and Mrs. Racine reported the entire original spread at the date of exercise as income, in conformity with the W-2 reporting by Mrs. Racine's employer. Even after giving effect to the withholding, their return for 2000 showed a balance due of \$210,292. Apparently unable to come up with that amount, the Racines paid \$64,000 with their return, leaving a significant unpaid balance.

In 2003 the Racines got advice from a tax attorney about a position they could take to attempt to eliminate that tax liability and, in fact, get back a refund of portion of the taxes withheld from the original exercise—that is, treating the margin loan as simply a new option and not a true exercise. The position that was taken was that only when the margin loans were actually paid was the option exercised—and, at that time, the value of the shares was substantially lower than at the original exercise.

A Form 1040X was prepared and filed advancing this position. The return was prepared by the attorney, who also prepared a Form 8275 to attach to the return. The IRS initially issued the refund plus interest to the Racines in January 2004.

However, in May 2004 the IRS opened an examination of their return and in July issued a notice of deficiency on their 2000 return, asserting that the amounts reported on the W-2 for the spread at the date of exercise of the original options was the amount that was required to be reported. The IRS also asserted an accuracy related penalty of \$102,892.40 under §6662(a).

## The Court's View

The court considered whether, in fact, the margin loan constituted a situation like that described in Reg. §1.83-3(a)(2) and Example 2 of Reg. §1.83-3(a)(7) or was distinguishable from the type of transaction described.

The Racine's argument was summarized as follows by the Court:

Petitioners maintain that the key factor involved is whether an employee has his or her own capital at risk. If there is no capital risk, according to petitioners, the transaction is nothing more than the grant of another option regardless of whether the debt is to the employer or to a margin account provider. According to petitioners, Congress intended to deny capital gains treatment to those who do not make any capital investment in their options. See *Palahnuk v. United States*, 70 Fed. Cl. 87, 92 (2006). Thus, according to petitioners, because Mrs. Racine exercised her options using a loan from CIBC and therefore had no capital at risk, no transfer occurred until CIBC sold the stock to satisfy the margin calls on Mrs. Racine's account.

The Court, however, rejected that approach, instead following the approach outlined in the *Facq* case decided earlier this year (TC Memo 2006-111). The court indicates that, in its view, it is important that the *employer* was involved in the transaction described in Example 2—so that, in this case, the employer was simply adopting an alternative method of giving the employee a right to purchase the property in question. In the end, the employee is only able to acquire the shares if he/she transferred the exercise price in cash to the employer—so nothing really changed when the note was issued.

In the Racine's case, the employer has been paid for the shares and transferred shares, unlike the employer in Example 2. Gail Racine borrowed from a third party (CIBC) to pay off her employer, and then executed an agreement with that party to use the shares as security for repayment of that obligation. The court found both that Gail's transaction was not like the one described in Example 2 and that it was not, in substance, the same as the grant of an additional option. Gail had title to the shares as well as the right to receive dividends, vote the shares and pledge them for a loan—which she, in fact, did. Thus she had substantial rights beyond those that would be available if she only owned an option.

The risk of decline in value of the shares was transferred away from the employer in this transaction, which the court ruled was the true issue to be concerned about, and not whether Mrs. Racine was personally liable.

Finally, the court noted that the issue was not whether the debt would be repaid out of cash, but whether the employer would receive the cash for the exercise price—and that had clearly occurred. Thus, for all of these reasons the court held the proper measurement date was that of the original exercise when the margin loans were taken out, and not when the loans were later repaid.

## Penalties

The court did not sustain the IRS on the issue of the penalties. The court noted that Mrs. Racine had no special expertise in U.S. tax law and reasonably sought the advice of a tax attorney and relied upon that advice. The court specifically noted that there was no obligation to obtain a “second opinion” since that would, in the view of the court, “nullify

the purpose of seeking the advice of an expert in the first place.” As well, the issue had yet to be litigated at the time the amended return was filed—so the return appeared to be both prepared in good faith and relied upon with the same good faith.

Unlike other cases we’ve looked at, here the taxpayers sought advice from someone who certainly had the stated qualifications to give them advice, and the advice given was not so far out of line with what was the state of the law at the time that it should have been obvious to a reasonable person that the position could not be sustained. It probably also didn’t hurt that the IRS itself let the refund go out the door before reversing course on this return, though a footnote reference makes it appear that the IRS accidentally let that refund “get away” from them.

## Lessons

One key lesson here is that clients who receive options need to understand the risk of a decline in value if they elect to hold the shares. In this case, the issue was doubly troubling since Mrs. Racine could have immediately sold the shares upon exercise, converted them to cash and then diversified her investment or, at least, set aside the additional cash that would be due to pay the tax in April. Unfortunately, quite often in cases like this, employees are so dazzled by the rapid run up in their employer’s stock that they believe the stock will continue to climb in price at the same rapid rate—and so look at holding the employer stock as a low risk option.

In most cases involving nonstatutory options, my clients have been able to resist that temptation and instead rationally considered that a lot of their financial well being was already tied up in the fortunes of their employer—so they immediately sold the shares and invested them elsewhere. The “bad news” cases I have seen in my practice have almost always involved ISO shares—and, in those cases, the damage was repaired by disqualifying the shares prior to December 31 of the year in which they were exercised, making use of §422(c)(2)’s special rule and the relief from AMT inclusion in such a situation.