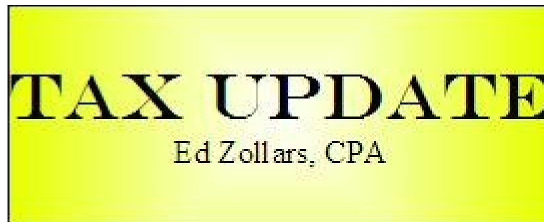

When Did That Happen? Options and the Exercise Date
Podcast for January 6, 2007

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Getting the Proper Price Date

This week's case deals with an issue of which date should have been used to value the exercise of a stock option. The taxpayer in the case of *Walter v. Commissioner*, TC Memo 2007-2, was arguing that the date the option was paid for should have been the measuring date. The IRS was arguing that, rather, the proper measuring date was the date the taxpayer informed the employer that he was excercising the option—which was also the date the employer used to value the option.

The Tax Court analyzed the nature of the option agreement with the employer to determine the date when beneficial interest transferred to the taxpayer to make its determination.

Options and Taxation

We've discussed before the basic rules found in Section 83 for options. The general rule found in Section 83 is contained in Section 83(a) which provides:

> (a) General rule
>
> If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of--
>
> (1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
>
> (2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

However, §83(e)(2) provides that the above does not apply to "the transfer of an option without a readily ascertainable fair market value" which covers almost all nonstatutory stock options that employees receive. In that case, §83(a) is not applied until the option is excercised.

When the option is exercised, we go back to the standard §83(a) measurement which looks at the fair value of the securities less the amount paid for those securities.

Regulation §1.83-3(a)(1) governs the date of the transfer and provides the following test:

> (a) Transfer
>
> (1) In general.
>
> For purposes of section 83 and the regulations thereunder, a transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in section 1.83-3(i)). For special rules applying to the transfer of a life insurance contract (or an undivided interest therein) that is part of a split-dollar life insurance arrangement (as defined in §1.61-22(b)(1) or (2)), see §1.61-22(g).

The issue becomes when the taxpayer obtained beneficial ownership in the asset in question—an issue we considered a few weeks back when looking at the issue of whether a taxpayer truly was the owner of shares exercised under a qualified option.

The Walter Case

In the Walter case, the taxpayer had been an employee of Primus Knowledge Solutions, Inc. through May 5, 2000, at which time his employment terminated. In July of 2000, Mr. Walter exercised his options. The exact method of exercise and transmission of the funds for pay for both the shares and the withholding due on the shares would come into play, so we have to follow the timeline in detail.

On July 13, 2000 Mr. Walter signed a notice of his intent to exercise his option on 44,791 shares and that the total due was $369,525.75 and check the box for payment of the shares for a "SAME DAY SALE: Exercise your stock options by selling all shares immediately." The notice was faxed to Primus after the close of business on that day.

However, by 7:30 am the next day Mr. Walter faxed a new statement that crossed out the same day exercise and rather indicated that he would "EXERCISE AND HOLD" the shares. He also faxed a cover sheet that indicated that the first fax was in error, and that he intended to hold the shares and that he was wiring $369,525.75 to Piper Jaffray, and that Piper Jaffray would forward those proceeds to Primus when they received them. On that same date (July 14) $370,000 was transferred from Mr. Walter's Charles Schwab account to Piper Jaffray.

Piper Jaffray transmitted the $369,525.75 to Primus in a check dated July 18, 2000. Another check was issued on July 20, 2000 for $385,711.80 to cover the withholding, most of which was borrowed from Piper Jaffray. Piper Jaffray prepared three confirmations on July 20, 2000, dealing with three individual option plans under which the options were exercised.

Over those few days, the price of Primus shares fell. Per day, here is the listing of the stock price:

Date	Closing Price	High/Low Average
July 14	$52.31	$52.4374
July 17	$46.25	$49.25
July 18	$38.00	$41.28
July 19	$40.0625	$40.685
July 20	$40.00	$41.375

Primus used the average of the high/low price on July 14 ($52.4375) to value the shares for W-2 reporting. Mr. Walter, on his Form 1040, used the closing price on July 19 of $40.0625 per share to value the shares.

Mr. Walter reported the total wages from the W-2, but then reported an "other

adjustment" of $366,795 to account for the difference in the valuation of the stock based on his belief that the July 19 date should be used.

So the question before the court was which date was the proper one?

Beneficial Interest and the Plans

To dcide the case, the Tax Court took a look at the details of the plans in question to determine when beneficial ownership actually transferred under the terms of the plan. The taxpayer took the position that this did not occur, under the terms of the plan, until Primus received payment for the shares on July 19.

The taxpayer noted that the letter he received granting the first two stock options contained the following language:

> The option may be exercised by the delivery of: (a) *Cash, personal check (unless, at the time of exercise, the Plan Administrator determines otherwise), bank certified or cashier's check*; or (b) Unless the Plan Administrator in its sole discretion determines otherwise, shares of the capital stock of the Company held by you for a period of at least six months having a fair market value at the time of exercise, as determined in good faith by the Plan Administrator, equal to the exercise price. * * * As a condition to the exercise of a non-qualified stock option, you shall make such arrangements as the Company may require for the satisfaction of any federal, state or local withholding tax obligations that may arise in connection with such exercise.

While the final option had similar language noted below:

> Unless the Plan administrator at any time determines otherwise, the option may be exercised by the *delivery of: (a) Cash, personal check, bank certified or cashier's check*; or (b) Shares of the capital stock of the Company held by you for a period of at least six months having a fair market value at the time of exercise, as determined in good faith by the Plan Administrator, equal to the exercise price.

Mr. Walter argued that these letters made it clear that the option was not truly exercised until he actually made the payment.

However, the Tax Court noted that each letter invoked, by reference, the 1995 Plan. That plan provided in Section 7.4 of the plan that said the employee may exercise the option by "by written notice to the Company, in accordance with procedures established by the Plan Administrator, setting forth the number of shares with respect to which the Option is being exercised and accompanied by payment in full as described in Section 7.5 of the Plan." Section 7.5 of the plan contained the following language:

> The exercise price for shares purchased under an Option shall be paid in full to the Company [Primus] by delivery of consideration equal to the product of the Option exercise price and the number of shares purchased. Such consideration

> must be paid in cash, except that the Plan Administrator may, either at the time the Option is granted or at any time before it is exercised and subject to such limitations as the Plan Administrator may determine, authorize payment in cash and/or one or more of the following alternative forms: (i) Common Stock already owned by the Holder for at least six months (or any shorter period necessary to avoid a charge to the Company's earnings for financial reporting purposes) having a Fair Market Value on the day prior to the exercise date equal to the aggregate Option exercise price; (ii) a promissory note authorized pursuant to Section 11 of the Plan; *(iii) if the Common Stock is publicly traded, delivery of a properly executed exercise notice, together with irrevocable instructions, to (a) a brokerage firm designated by the Company to deliver promptly to the Company the aggregate amount of sale or loan proceeds to pay the Option exercise price and any withholding tax obligations that may arise in connection with the exercise* and (b) the Company to deliver the certificates for such purchased shares directly to such brokerage firm, all in accordance with the regulations of the Federal Reserve Board; or (iv) such other consideration as the Plan Administrator may permit.

The Court held that by the notice given on the morning of July 14 satisfied the written notice requirement, and that the 1995 plan specificially authorized payment to be made via the brokerage firm designated by the Company (in this case, Piper Jaffray). The letter did not limit the payment options since it referenced the 1995 plan specifically. As well, both Primus and Piper Jaffray treated the shares as being Mr. Walter's as of July 14, rather than the July 19 date.

The Court considered that, although not argued by the taxpayer, there may have been an argument that his notice was “defective” because it did not provide for payment of the withholding tax. The Court decides that this did not invalidate the notice because it was clear under the terms of the plan that Mr. Walter had an obligation to forward such funds and Primus had acted as if the notice it had received was sufficient under the plan. The court noted that “Primus's view on the date on which petitioner exercised his options is especially probative here where, notwithstanding the applicability of section 7.5(iii) of the 1995 Plan, section 7.5(iv) of the 1995 Plan allowed the plan administrator to accept in exercise of the options any form of consideration that it desired.”

The Court notes that as of July 14, Mr. Walter could have sold the shares—and, in fact, originally would have done so had he not changed his instructions at the last minute. Thus, it was clear that he had beneficial ownership as of that date. The Court concludes:

> Also on July 14, 2000, petitioner incurred the risk of a beneficial owner that the value of his Primus stock would decline. According to his notice, petitioner determined to eliminate this risk by electing to sell all of his Primus stock immediately after exercise. When petitioner changed his mind and canceled his sell order, he chose to hold his Primus stock and to bear the risk of a decline in its

value.

Considerations

A couple of interesting points can be made about this case. First, as is true with many employee benefits, the actual language of the documents that make up the plan may turn out to be extremely important in determining the consequence of various transactions from a tax standpoint. In most of these areas (including qualified plans) the IRC contains broad outlines that define the boundaries of what is allowed or possible—but the detailed plan must be studied to determine the actual impact.

As well, it's important to note that in many contexts under the tax law, the question becomes not necessarily when formal legal ownership of an asset changes, but rather when the *beneficial* ownership of the property is transferred. As we've seen in a couple of cases recently, the fact that the taxpayer may argue that technically he/she was not the owner formally of the property is not enough to escape or delay the tax consequence of the transaction. Rather, when the risks and benefits of ownership become the taxpayer's own, he/she ends up recognizing the transaction.