Frivolous Arguments to Avoid Concerning Statutory and Nonstatutory Stock Options

Notice 2004–28

The Internal Revenue Service is aware that certain promoters are advising taxpayers to take highly questionable, and in most cases meritless, positions, described below, on current and amended returns regarding income or alternative minimum tax ("AMT") due upon the exercise of nonstatutory or statutory stock options. This notice alerts taxpayers that the Service intends to challenge such positions and will treat them as frivolous in appropriate cases. However, the Service will consider each position and will not reject or contest it solely because it is submitted along with a frivolous position. *See* Treas. Reg. § 1.6694–2(c)(2) ("a 'frivolous' position with respect to an item is one that is patently improper"). The Service also may apply civil or criminal penalties to taxpayers and to promoters of these positions.

Income Tax Treatment of Stock Options Generally

The federal income tax treatment of stock options granted in exchange for services is well established. In general, the income tax consequences associated with an option arise when the option is exercised. When an employee exercises a compensatory stock option (commonly known as a "nonstatutory option"), both § 83 of the Internal Revenue Code (Code) and long-standing judicial authority require that the difference between the fair market value of the stock and the option exercise price be included in the employee's gross income as compensation. *See, e.g.*, Commissioner v. LoBue, 351 U.S. 243 (1956). In the case of stock purchased under an incentive stock option (or a "statutory option") taxed under §§ 421 and 422, § 56 provides that the difference between the fair market value of the stock and the option exercise price must be included in the employee's gross income for purposes of computing AMT.

Statutory stock options are not subject to tax on the date of grant. Nonstatutory stock options rarely are subject to tax on the date of grant, and taxation at grant

typically occurs only if an option is actively traded on an established securities market on that date or, if not so traded, it has a readily ascertainable fair market value. *See* § 83(a) and (e), and § 1.83–7(a) and (b) of the Income Tax Regulations. A non-publicly traded nonstatutory stock option is considered to have a readily ascertainable fair market value on the grant date only if, on that date, it satisfies four conditions: (1) the option is transferable; (2) the option is exercisable immediately in full by the optionee; (3) the option or the property subject to the option is not subject to any restriction or condition which has a significant effect upon the fair market value of the option; and (4) the fair market value of the option privilege is readily ascertainable. § 1.83–7(b).

For more information regarding the federal tax treatment of stock options granted in exchange for services, please consult Publication 525, *"Taxable and Nontaxable Income,"* pages 9–11.

Positions Promoted

The positions being promoted include, but are not limited to, the following:

- **"The options should have been taxed at their grant date rather than their exercise date."** Promoters of this argument typically claim that the proper time for an employee to measure taxable income from a stock option is when the option is granted (before the stock has appreciated) rather than when it is exercised (after the stock has appreciated). This claim will rarely be supported by the facts. For a nonstatutory option, unless the requirements for taxation at grant as described above are satisfied, the proper time for measurement and inclusion of income is on the date of exercise. A statutory option will never be subject to tax on grant. *See* §§ 421 and 422.

- **"The fair market value of stock purchased under an option is reduced by any restriction placed on the stock by the employer that prohibits the employee from selling the stock for a specified period of time."** Promoters of this argument typically claim that if an employee cannot sell stock purchased under an option for a period of time because of an agreement with an employer, then the value of the stock cannot be as high as the value of the same stock that does not have that restriction. This claim is without merit because § 83(a) clearly requires that the value of property transferred in connection with the performance of services must be determined without regard to restrictions that will lapse, such as a requirement to hold shares for a period of time. *See also* § 1.83–1(a)(1) and *Sakol v. Commissioner*, 67 T.C. 986 (1977), *aff'd*, 574 F.2d 694 (2nd Cir. 1978), *cert denied*, 439 U.S. 859 (1978).

- **"When, due to a margin call, a broker sells a taxpayer's stock that was purchased under a nonstatutory option, the stock having been pledged as security for a loan to pay the exercise price, that sale is a forfeiture of the stock that causes an ordinary loss rather than a capital loss."** Promoters of this argument generally claim that a sale of stock required by a broker's margin call should be treated as an ordinary loss. This claim is baseless because, when an employee is the beneficial owner of shares held by the employee's broker pursuant to a stock option exercise, the stock is then a capital asset to the employee. *See* § 1221. Capital gains or losses occur upon the subsequent sale of the stock, such as pursuant to a margin call. The same analysis applies for purposes of AMT, and gain or loss on disposition due to a margin call would be capital gain or loss for AMT purposes. *See* §§ 56, 421 and 422.

- **"The purchase of the stock using borrowed funds was not in substance a purchase because the employee did not have the ability to repay the loan."** Promoters of this argument typically assert that an employee's purchase of shares pursuant to a stock option in exchange for a note to pay the purchase price should not be respected where the employee is subsequently unable to pay the debt. This claim will fail where, in fact, beneficial ownership of the stock was transferred to the employee, irrespective of the employee's subsequent ability to repay the debt. *See* § 1.83–3(a).

- **"Options should have been viewed as the economic equivalent of the underlying stock and thus were not subject to any taxation of the spread on exercise."** Promoters of this argument typically claim that because an option and the underlying stock are functional equivalents, there is no gain when the employee exercises the option. As discussed above, generally, when an employee is granted a nonstatutory option, § 83 requires the inclusion of income equal to the difference between the stock's fair market value and the exercise price when the option is exercised. Section 56(b)(3) requires the employee to include that difference in AMT income when an employee exercises a statutory stock option.

These positions and other similar claims that disregard the long-standing judicial and statutory authorities concerning the taxation of statutory and nonstatutory options will be treated as frivolous in appropriate circumstances.

In evaluating positions of this kind, the Service will determine the additional tax due from the taxpayer according to the principles outlined above. In addition to liability for tax due plus statutory interest, individuals who claim tax benefits on their returns based on these and other frivolous arguments face substantial civil and criminal penalties. Potentially applicable civil penalties include: (1) the § 6662 accuracy-related penalty, which is equal to 20 percent of the amount of taxes the taxpayer should have paid; (2) the § 6663 penalty for civil fraud, which is equal to 75 percent of the amount of taxes the taxpayer should have paid; (3) a $500 penalty under § 6702 for filing a frivolous return; and (4) a penalty of up to $25,000 under § 6673 if the taxpayer makes frivolous arguments in the United States Tax Court.

Taxpayers filing returns based on these or similar positions also may face criminal prosecution for: (1) attempting to evade or defeat tax under § 7201 for which the penalty is a fine of up to $100,000 and imprisonment for up to 5 years; or (2) making false statements on a return under § 7206 for which the penalty is a fine of up to $100,000 and imprisonment for up to 3 years.

Persons who promote these or similar positions and those who assist taxpayers in claiming tax benefits based on them also face penalties. Potential penalties include: (1) a $250 penalty for each return prepared by an income tax return preparer who knew or should have known that the taxpayer's argument was frivolous (or $1,000 for each return where the return preparer's actions were willful, intentional or reckless); (2) a $1,000 penalty under § 6701 for aiding and abetting the understatement of tax; and (3) criminal prosecution under § 7206 for which the penalty is a fine of up to $100,000 and imprisonment for up to 3 years for assisting or advising about the preparation of a false return or other document under the internal revenue laws. Promoters and others who assist taxpayers in engaging in these schemes also may be enjoined from doing so under § 7408.

Taxpayers who have submitted returns relying on these or similar claims should amend them as soon as possible to avoid accruing additional penalties. Taxpayers should consult with a tax advisor to take appropriate corrective action.

For more information regarding the taxability of stock options, taxpayers can contact the Office of Division Counsel/Associate Chief Counsel (Tax Exempt/Government Entities) at (202) 622–6030 (not a toll-free call). For information regarding AMT, contact the Office of Associate Chief Counsel (Income Tax & Accounting) at (202) 622–4920 (not a toll-free call). For information regarding penalties, contact the Office of Associate Chief Counsel (Procedure and Administration) at (202) 622–4940 (not a toll-free call).