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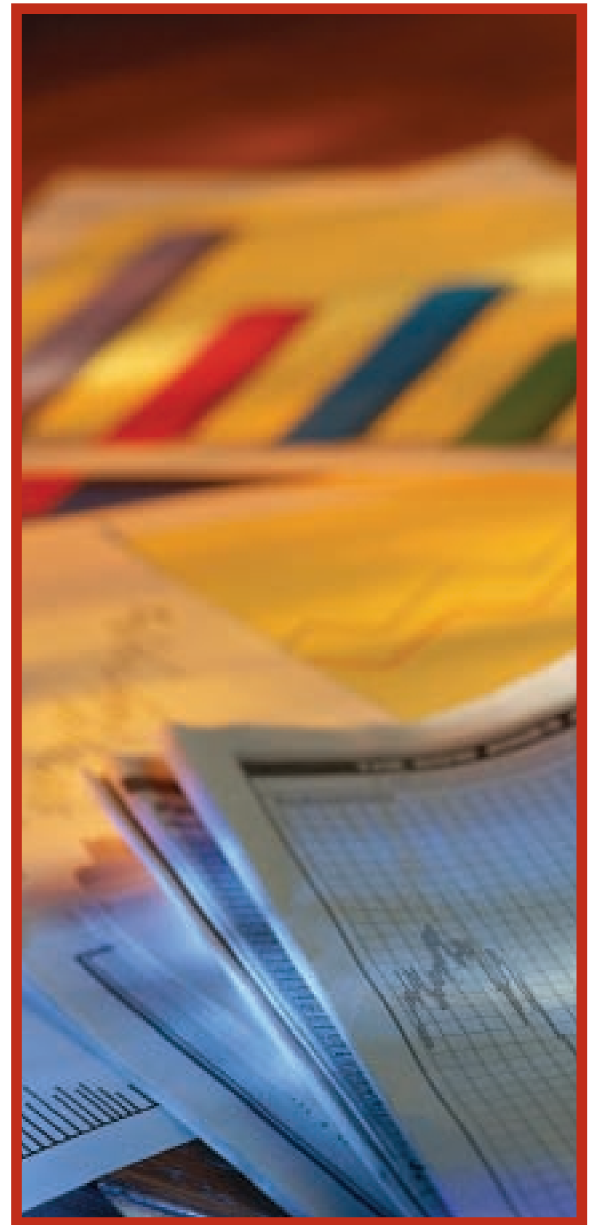

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Dating games

Backdating stock options can ensnare public — and closely held — companies

It's been about a year since the stock option backdating scandal became almost daily fodder for financial pages across the United States. Today, well over 100 of the country's largest corporations are under investigation for illegal backdating, and scores of executives and directors have been forced to resign. Although public companies continue to grab the headlines, even closely held companies are getting caught in the backdating trap.

How options work

Despite all the attention backdating has received, the concept remains widely misunderstood. For various accounting and tax reasons, most employee stock options are granted "at the money," which means their exercise or "strike" price is equal to the underlying stock's fair market value (FMV) on the grant date. So the lower an option's strike price, the more valuable the option is to the recipient.

Stock options are most common in public companies, but many closely held businesses also offer them as an incentive to executives and other employees.

Backdating means selecting a stock option grant date that's earlier than the actual grant date to take advantage of rising stock prices. Let's say, for example, your company grants you options to buy 5,000 shares of stock on July 1 when the stock's FMV is $100 per share. If the company backdates the options to May 1, when the stock's FMV was $80 per share and sets an $80 strike price, you enjoy an instant profit of $100,000, even though the options appear to have been granted at the money.

Why businesses backdate

To understand why a company would backdate stock options, you need to know how options are accounted for and taxed, from a financial statement point of view. Before 2006, businesses could grant at-the-money stock options without reporting compensation expenses until the options were exercised. This enabled them to provide an attractive benefit to executives with no immediate impact on earnings. By backdating options, companies could boost an executive's profits without taking an earnings hit.

But the accounting rules have changed. Now, employee stock options must be expensed at fair value. This virtually eliminates the accounting advantages of backdating.

From a tax perspective, there are distinct advantages to granting stock options at the money. Generally, options aren't taxed until they're exercised or, in the case of incentive stock options (ISOs), until the stock is sold. Under current law, however, "discounted options" — those with a strike price less than the stock's FMV on the grant date — may result in severe tax consequences for the company and the employee.

How improper backdating can be taxing

Contrary to popular belief, backdating is legal as long as it's properly disclosed in the company's financial statements, reflected in the company's earnings and reported for tax purposes.

Practically speaking, there's little reason to backdate options if these conditions are met. In most cases, the companies implicated in the scandal backdated options for the very purpose of avoiding these accounting and tax requirements.

The consequences of improper backdating can be severe. In addition to significant restatements of earnings, public companies and their officers and directors risk criminal and civil liability under federal securities laws. Investors may bring lawsuits alleging that management improperly enriched top executives at the expense of shareholders.

Stock options are most common in public companies, but many closely held businesses also offer them as an incentive to executives and other employees. Private companies generally are not subject to the federal securities laws, but they can still be ensnared in the backdating trap. Substantial earnings restatements may upset investors, lenders and other creditors or cause the company to violate loan covenants. And shareholders may sue officers or directors, alleging that they breached their fiduciary duties by backdating options without proper disclosure. In some cases, companies that conceal backdating on their financial statements may be accused of fraud.

Improper backdating can also have serious tax consequences. Options deemed to be granted at less than FMV can trigger taxes, penalty and interest for the company and its executives, not to mention disqualifying ISOs.

In addition, backdating can affect the deductibility of executive compensation. Currently, there's a $1 million cap on deductible compensation paid to top executives of publicly held companies for federal tax purposes. There's an exception for "performance-based" compensation, which includes stock options granted at FMV. If backdated options are recharacterized as discounted options subject to the cap, the IRS may deny earlier deductions and assess back taxes, penalties and interest.

Why you need to take stock of your options

If your company grants stock options to employees, it's important to review your program to ensure you're not guilty of improper backdating — either intentional or inadvertent. To avoid even the appearance of impropriety, be sure your stock option policies and practices are consistent and properly documented.

3 tax-wise strategies for sharing your wealth

Is your net worth large enough that estate and gift taxes are a concern? If so, there are several estate planning techniques that allow you to minimize taxes and preserve more of your wealth for your loved ones. Here are three strategies.

1. Irrevocable life insurance trust

If you own your life insurance policy, the proceeds will be included in your estate and nearly half of its value may be lost to estate taxes. You can avoid that scenario by setting up an irrevocable life insurance trust (ILIT) to buy and hold the policy. This allows the proceeds to bypass your estate and go to your loved ones tax-free.

For an ILIT to work, it must be designed carefully. To keep the insurance proceeds out of your estate, you can't retain any "incidents of ownership" in the policy, such as the right to change beneficiaries or the right to cancel, surrender, pledge or borrow against the policy.

And, if possible, the trust should buy the policy. Although you can transfer an existing policy to an

ILIT, the proceeds will be included in your estate if you possess any incidents of ownership within three years before you die.

The funds you contribute to the trust to pay insurance premiums and other expenses are taxable gifts to your beneficiaries. But you can avoid gift tax by using your lifetime gift tax exemption (currently, $1 million) or your annual gift tax exclusion ($12,000 per recipient in 2007). To qualify for the annual exclusion, however, contributions must be considered "completed gifts," which means that your beneficiaries must be given the right to withdraw the funds for a limited time (usually 30 days).

2. Qualified personal residence trust

If you'd like to continue living in your home while reducing your estate, consider a qualified personal residence trust (QPRT). It allows you to transfer your principal residence or vacation home to your children or other beneficiaries at a reduced tax cost — all while retaining the right to live in the home for a specified term.

When you transfer a home to a QPRT, any future appreciation of the home is sheltered from estate tax. And the value of your initial gift for gift tax purposes is based on your beneficiaries' remainder interest in the home, which is only a fraction of its current value.

It's important to select the trust term carefully because the longer the term, the lower the value of the remainder interest. But a QPRT is effective only if you survive the term. Keep in mind that, after the trust expires, your home is owned by the trust or, if the terms call for it to be distributed, the trust beneficiary or beneficiaries. Of course, you can continue living in the home — as long as you pay fair-market rent to the owner.

Special considerations apply if the home is subject to a mortgage or if your beneficiaries are grandchildren or others, which might raise generation-skipping transfer (GST) tax issues.

3. Charitable remainder trust

If philanthropy is one of your estate planning objectives, a charitable remainder trust (CRT) can help you achieve that goal while providing current tax benefits for you and your family. To take advantage of this technique, transfer assets to an irrevocable trust that pays income to you or your beneficiaries for life or a specified term and then distributes the remaining assets to a qualified charity.

A CRT is ideal for converting highly appreciated assets into a current income stream. Suppose you own real estate that has appreciated significantly in value. You'd like to sell the property and put the proceeds into income-producing investments, but you'd have to pay taxes on the capital gains.

If, instead, you contribute the property to a CRT, which is a tax-exempt entity, the trustee can sell the property tax-free and reinvest in a diversified portfolio. You defer — and potentially avoid — capital gains taxes and enjoy a regular stream of income (subject to income taxes, of course). You're also entitled to a current income tax deduction for the value of the charity's remainder interest.

Keeping it in the family

ILITs, QPRTs and CRTs are just a few of the techniques you can use to share your wealth with your family at a lower tax cost. Finding the right strategy for you will depend on your specific financial situation and estate planning goals.

How to minimize taxes when giving away your retirement savings

If your hard work and good fortune enable you to share some of your wealth with charities, it's important to consider the tax implications. After all, the less you pay in taxes, the more you have left to support the causes you care about.

An effective charitable giving strategy is to donate tax-deferred retirement plan assets, such as traditional IRAs or 401(k) accounts. Why? Because retirement plan assets left directly to charity escape both federal income and estate taxes. (Keep in mind that not all states follow federal law.) And recent developments have made it easier than ever to leverage your retirement savings to make tax-efficient gifts. Let's review how you can maximize retirement plan donations.

The charitable deduction might offset the income tax on the IRA withdrawal, but you must itemize and the gift has to be within applicable income limits.

Not all assets are created equal

When deciding how to share your wealth — with family members, charities or others — the type of assets you give has a lot to do with how much your family ends up sharing with Uncle Sam. Here's an example:

Harry has two adult children, Nancy and James. When Harry dies in 2007, his assets consist of a $600,000 IRA, $600,000 in cash, and $600,000 in stocks, bonds and real estate. With a total value of $1.8 million, his estate is well within the $2 million exemption, so federal estate taxes don't apply.

James is the sole beneficiary of Harry's IRA. In his will, Harry leaves the securities and real estate to Nancy and the cash to several of his favorite charities. Harry believes he's treating his children equally, but that assumption is incorrect when you consider the impact of income taxes.

Nancy receives the full value of the assets Harry leaves her. Because her tax basis in the assets is "stepped-up" to their fair market value at the time Harry dies, she could turn around and sell them tax-free. But James is subject to ordinary income taxes on Harry's IRA assets. Assuming that James takes a lump-sum distribution of the IRA funds, and that his effective tax rate (including state taxes) is 40%, his $600,000 inheritance shrinks to $360,000.

Harry could have avoided this result had he named the charities as beneficiaries of his IRA and left the cash to James. Harry's children would have received equal shares of his wealth and the charities — which are exempt from income taxes — would have enjoyed the full value of his IRA assets. This simple adjustment to Harry's estate plan would have avoided $240,000 in income taxes.

Limited-time offer for lifetime gifts

Two tax law changes in recent years make it easier — and less costly — to donate retirement plan assets to charity. One reduces the tax cost of naming a charity as a beneficiary of your IRA or qualified retirement plan. The other, which expires at the end of this year unless Congress extends it, allows seniors to transfer up to $100,000 in traditional IRA assets directly to a charity without triggering any income tax.

Owners of traditional IRAs and, with certain exceptions, 401(k) and other employer-provided retirement plans must take "required minimum distributions" (RMDs) beginning after they reach age 70½. So, previously, the only way to make a lifetime gift of IRA funds would be to take a taxable distribution from the IRA and then make a gift to charity.

The charitable deduction might offset the income tax on the IRA withdrawal, but you must itemize and the gift has to be within applicable income limits. (Generally, you can deduct cash donations to the extent that they're less than 50% of your adjusted gross income.) Depending on your income, some of the contribution may be lost due to itemized deduction phaseouts. Additionally, not all states allow itemized deductions.

The Pension Protection Act of 2006 (PPA) allows you to make a tax-free qualified charitable distribution (QCD), regardless of your income level and whether you itemize (provided the gift is otherwise deductible). As an added bonus, a QCD counts toward any RMDs in the year it's made, generating additional tax savings. To qualify, you must also meet these requirements:

- Be age 70½ or older when the distribution is made.
- Make the distribution, which must be otherwise taxable, no later than Dec. 31, 2007, from a traditional or Roth IRA.
- Make the distribution *directly* from the IRA to a qualified charity other than a donor-advised fund or supporting organization.

Remember that you can't make QCDs from a SIMPLE IRA, SEP-IRA, 401(k), 403(b) or other employer-sponsored retirement plan. But you may be able to take advantage of the QCD rules by rolling over assets from one of these plans into an IRA. In most cases, Roth IRAs aren't appropriate vehicles for a QCD because distributions generally are already tax-free.

Give and take: Recent tax law changes to donations are a mixed bag

The Pension Protection Act of 2006 (PPA) contains several provisions that affect charitable donations. Some, like the one allowing direct gifts from an IRA, make charitable giving easier. But others tighten restrictions on charitable deductions. Here's a sampling:

- A deduction is now available for donations of used clothing or household items (such as furniture and appliances) only if they're in "good" condition. There's an exception for single items worth more than $500, provided you file a "qualified appraisal" with your tax return.
- Cash contributions, no matter how small, must be substantiated by bank records or receipts to be eligible for the deduction.
- The benefits of donating fractional interests in artwork and other collectibles have been reduced.

The gift that gives back

Donating some or all of your retirement savings to charity — either during your life or at your death — can fulfill your philanthropic goals while providing valuable tax benefits for you and your family. Keep in mind that there are several strategies that can help you meet both objectives, so be sure to plan and consult your tax advisor.

Tax Tips

Take advantage of revitalized tax benefits

Late last year, President Bush signed the Tax Relief and Health Care Act of 2006. In addition to introducing new rules and tax breaks, the legislation revives several important tax benefits that had expired or were about to expire. For example, it:

- Extends the Research tax credit, which had expired at the end of 2005, to qualifying expenses incurred in 2006 and 2007, and creates new rules for 2007 that will make the credit more valuable for some organizations,
- Restores the option to deduct sales taxes in lieu of state income taxes, which had expired at the end of 2005, through 2007,
- Brings back the above-the-line higher education tuition deduction for 2006 and 2007,
- Renews the Work Opportunity and Welfare-to-Work credits for 2006 and combines them into a single credit for 2007, and
- Extends several energy incentives, including the energy-efficient commercial buildings deduction and the Energy-Efficient Homes credit for contractors, through 2008 — they had been scheduled to expire at the end of 2007.

As you tax plan for this year and next, be sure to consider how these changes may affect your or your business's financial situation.

No capital gains in certain instances

From 2008 through 2010, the tax rate on certain capital gains and qualified dividend income will drop from 5% to zero for taxpayers in the 10% and 15% tax brackets. Assuming that Congress doesn't eliminate this favorable rate between now and then, it offers some interesting planning opportunities. For example, recent retirees may be able to allocate their assets in a way that puts them into the 15% bracket. By liquidating capital assets to meet their income needs, it may be possible to shelter the capital gains from taxes.

Parents can also take advantage of favorable capital gains and dividend rates by making gifts of capital assets to children with little or no income. To avoid the "kiddie tax" — which applies the parents' marginal tax rate to certain unearned income of children under age 18 — these gifts generally should be made after a child turns 18. But, if the student is or will be attending college, consider how the gift may affect his or her financial aid. Also, watch for potential tax law changes, which may place greater restrictions on lower capital gains and dividend rates for dependents under age 24.

Why you should consider a like-kind exchange

Internal Revenue Code Section 1031 allows you to exchange one piece of real property for another without recognizing any gain, provided you use both properties in a trade or business or for investment purposes. A like-kind exchange is one strategy you can use to diversify real estate investments or relocate a business without triggering current taxes on the capital gains. The taxes are deferred until you sell or otherwise dispose of the replacement property.

To qualify, you must meet a number of requirements, including identifying replacement property within 45 days after the relinquished property is sold and completing the exchange within 180 days. A "qualified intermediary" must be used to hold the sale proceeds and acquire the replacement property.

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good works partner

Dear reader:

Did you know that retirement plan assets left directly to charity are not subject to both federal income and estate taxes? Or that ILITs, QPRTs and CRTs are just a few of the techniques you can use to share your wealth with your family at the lowest possible tax cost? These topics plus how to take advantage of revitalized tax benefits and how to avoid backdating stock options are some of the valuable articles in this newsletter. For more information on these and other topics of value to your tax planning, please contact me or any of our highly qualified members of the Tax Department at MBAF.

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