

# **Taxes are still certain: individual tax consequences under Sarbanes Oxley**

Kathryn A. Hansen  
California State University – Los Angeles

Edward L. Monsour  
California State University – Los Angeles

## **ABSTRACT**

With the advent of the Sarbanes-Oxley Act of 2002, corporate executives, if convicted under certain provisions of the act, may have to reverse certain payments received from the corporation or give up profits gained on transactions of corporate stock. Since many of these transactions initially had tax consequences to the executive, reversal also creates tax consequences. In this paper, we delineate the transactions that would have tax consequences to the individual executive and explain the tax effects.

Keywords: Sarbanes-Oxley, individual taxation

## INTRODUCTION

Conventional wisdom says the only certain things in life are death and taxes. Both consequences may occur under provisions of the Sarbanes-Oxley Act of 2002. Death here refers to the potential death of a CEO's or CFO's career, if he is charged and convicted of violating the Sarbanes-Oxley Act (hereafter, the Act or SOX) (Sarbanes Oxley Act, 2002). The taxes occur because of several provisions in the Act that require certain individuals to disgorge any profits they have made during the term of the financial malfeasance.

Five types of economic transactions can trigger tax consequences under the Act. They include

1. Bonuses or incentive-based compensation received during the period of financial malfeasance.
2. Equity-based compensation during this time period.
3. Profits realized from security sales during this time period.
4. Profits realized from the sale of stock during any blackout periods.
5. Forgiveness of previously granted loans that cannot be renewed under the Act.

For each of the above provisions of the Act, we explain the provisions set forth in the Act and analyze the tax consequences as they relate to a fictional executive found to have violated each specific section. For purposes of illustration of these provisions, we use John Smith, CEO of ZYX, Inc., as an example, and we assume that John Smith is in the top marginal tax bracket. While we use a CEO in the examples, these consequences could also apply to a CFO.

## BONUSES AND INCENTIVE PAY

When a company is required to restate its financial data as a result of material misconduct under the Act, the CEO and/or the CFO must reimburse the company for any bonuses and incentive-based pay received and gains on stock sales in connection with the filing of an "accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirement under the securities laws" during the specific recapture period. (SOX, § 304(a) (1)) In most industries, incentive-based compensation also includes stock options. Receiving stock options doesn't provide cash to the holders at the time of the grant, but it can create a taxable event, and the holder needs to pay taxes when stock options are granted or exercised depending on the grant restrictions. (IRC §83(a); Reg. §1.83-3(c)) If the grant occurs during the period of financial misconduct, the Act requires that the incentive-based pay must be reimbursed to the company. With the reimbursement, any tax consequences recognized would also be reversed.

If the non-qualified stock options are not traded on an open market and do not have a fair market value (FMV), then the stock options are not taxable to the employee on the grant date. Instead, the stock options are taxable at the exercise date. The employer receives a deduction in the year the employee recognizes compensation income either on the grant date or, more likely, the exercise date. (IRC §83 (h))

Let's assume that during FY 2007, Smith received a bonus of \$6.5 million. This bonus must be returned to ZYX. Because the repayment is required under the Act, Smith is allowed a deduction for the repayment of the bonus in the year it is paid. (Van Cleave v. US) Smith needs

to calculate his current year's tax with a deduction for the bonus of \$6.5 million and recalculate the 2007 tax liability excluding the bonus from his income. Smith gets a tax benefit for the *lesser* of either the current year's reduction in tax or the change in the prior year's tax. (IRC §1341) If we assume that Smith is in the top marginal tax bracket in both years (2007 and the current year), he would receive a tax benefit of \$2,275,000<sup>1</sup> upon repaying the bonus.

Smith also received two stock option grants at two different times during FY 2007. The first consisted of 1,000,000 options at an exercise price of \$13.75, which is more than the fair market value of the stock on the grant date. The second, later grant consists of 200,000 options with an exercise price of \$15.00; again, the fair market value is less than the exercise price. Since the fair market price of the stock options on both grant dates was lower than the stated exercise price, there were no tax consequences to Smith on either grant date. (IRC §83) Therefore, as long as Smith does not exercise the stock options, there will be no tax consequences to him when he returns the options to ZYX.

Now, let's assume that Smith has exercised the options from the earlier grant of stock options. When Smith exercised the options, the FMV was \$14.75 and the exercise price was \$13.75. Smith would recognize ordinary income of \$1,000,000, which is the difference between the exercise price and the FMV (\$1 times the 1,000,000 options exercised). Smith would have tax consequences when he returns the gain of \$1,000,000 to ZYX, Inc., and he would be entitled to reduce his income by that amount. Using the top bracket for 2007 (35%), the repayment - deduction of \$1,000,000 would result in a tax savings of \$350,000.

As long as Smith hasn't exercised the later group of stock options, the return of the stock options to ZYX creates no taxable event. (SOX, §304)

## **EQUITY-BASED COMPENSATION**

Other forms of equity-based compensation, such as restricted stock awards, received during the period of financial misconduct, also must be paid back to the company. (SOX §304 (a) (1)) Deferred compensation also falls under this category so that any such benefits received by the CEO/CFO will be returned to the company. (The American Jobs Creation Act of 2004 added more restrictions on how deferred compensation should be treated. (IRC §409A)) Employees who receive restricted stock as compensation for the performance of services do not recognize the fair market value of the stock as income until the year in which the risk of forfeiture lapses. (IRC §83(a)) Employees may elect, however, to recognize the fair market value as income in the year of receipt. (IRC § 83 (b)) However, the employee has only 30 days after receipt to make the election. An employee would consider this election only if he expects the fair market value of the stock to increase significantly during the restriction period.

Smith received a restricted stock award with a value of \$1,500,000 in 2006. Assuming he did not elect to recognize the fair market value as income in the year of receipt, there are no tax consequences to either Smith or the corporation when he gives the stock back.

If, however, Smith made an election to recognize \$1,500,000 as ordinary income in 2006, then ZYX would have been allowed a compensation deduction in the amount of \$1,500,000 for the 2006 tax year. Consequently, Smith's tax basis in the stock is \$1,500,000. Even though he

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<sup>1</sup> \$6,500,000 \* .35. The change in 2007 taxes would be figured at the marginal tax rate of 35% which would be higher than the 2003 rates.

must return the stock awarded to the corporation in 2007, Smith may not deduct his \$1,500,000 unrecovered basis in the forfeited shares. (IRC §83(b) (1))

When Smith returns the shares to ZYX, there are no personal tax consequences whether or not he made the election. (Ibid.) However, if he made the election, he recognized \$1,500,000 as ordinary income in 2006, which he cannot deduct in 2007 when he returns the shares.

## REALIZED SECURITY GAINS

The Act also requires that any profits realized from the sale of the company's securities during the year of the financial misconduct be reimbursed to the company. (SOX § 304 (a) (2)) This section not only refers to stock received as part of a compensation plan but also any stock individually owned by the CEO/CFO.

Assume that in 2006 Smith sells the 1,000,000 shares he received when he exercised the first grant of stock options at \$15.25 a share. His realized gain is the difference between the exercise price of the stock options and the sales price, less any selling commissions. Ignoring the effect of sales commissions, his proceeds from the sale total \$15,250,000. Subtracting the basis of \$13,750,000,<sup>2</sup> Smith's realized gain is \$1,500,000. He must reimburse this amount to ZYX, Inc.

For the options not exercised during the period of misconduct, Smith has an unrestricted right to the options. (IRC § 1341 (a) (1)) Under the claim-of-right doctrine, if a taxpayer is required to pay back an amount in the current year which was included in income in the previous year, a deduction in the current of previous year is permitted. (IRC §1341 (a); Reg. §1.1341-1) Therefore Smith is entitled to the claim of relief when the realized gain was restored to the company.

Smith may deduct the \$1,500,000 realized gain in the year it is repaid. (Van Cleave v. US) Smith must recalculate his 2001 tax liability, excluding the realized gain from his income. Smith receives a tax benefit for the *lesser* of either the current year's reduction in tax or the change in the prior year's tax. (IRC § 1341 (a) (4) and 1341 (a) (5))

To illustrate the amount of tax relief available, we use the following assumptions:

- The realized gain is \$1,500,000 and it is a long term capital gain (if exercised at \$13.75),
- The marginal tax rate for the year 2003 was 39%, assuming Smith's income placed him in the highest tax bracket,
- The marginal tax rate for the year 2006 was 35%,
- The tax relief is calculated by applying the top marginal tax rate to the realized gain.

Tax relief is \$525,000 as calculated based on the following:

The lesser of:  $35\% * \$1,500,000 = \$525,000$  or  
 $39\% * \$1,500,000 = \$585,000$ .

Under the claim of right, provision of federal law, a taxpayer is entitled to recalculate taxes previously paid, but subsequently discovered to have been paid in error. The federal statute

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<sup>2</sup> \$13.75 \* 1,000,000

allows the taxpayer to recalculate taxable income and taxes for the year during which the amount is returned, and take either a deduction or a credit.

However, in Smith's case, for the options exercised and sold during the period of misconduct, he will not be entitled to the claim of relief. (IRC § 1341) Therefore, not only does Smith have to restore the realized gain back to ZYX, he is not entitled to the tax relief of the restoration for the shares that were both exercised and sold during the period of malfeasance.

## **BLACKOUT PERIOD PROFITS**

Companies can declare “blackout” periods during which employees owning company stock in the pension or 401(k) plans cannot trade or sell their shares. If, during this blackout period, an executive or director sells, purchases, or transfers any company security acquired, as a result of his or her employment, then the company can recover any realized profits. (SOX §306(a)) These profits can be recovered in court proceedings by either the company or other owners on behalf of the company, if the company fails to institute legal proceedings. A “blackout” period means “any period of more than three consecutive business days during which the ability of no fewer than 50 percent of the participants or beneficiaries under all individual account plans maintained by the issuer to purchase, sell or otherwise acquire or transfer an interest in any equity security of such issuer held in such an individual account plan is temporarily suspended by the issuer or by a fiduciary of the plan.” (SOX § 306 (a) (4) (A))

To illustrate, assume that a blackout period occurs in 2003 with respect to the company’s pension plan. Smith realizes profit on the sale of ZYX stock during the “blackout” period. He acquired the stock outside his pension account through his employment as an executive officer. The transaction is subject to the Act. (SOX § 306 (a) (5)) In order to prevent directors and executive officers (corporate insiders) from trading stock to their advantage when employees of the issuer cannot trade their securities in their retirement plan accounts, any proceeds must be returned to the firm.

The Sarbanes-Oxley Act requires, any profit realized by a director or executive officer from any sale in violation of the Act to inure to and be recoverable by the issuer. (SOX § 306 (a) (2) (A)) Therefore, the profits realized by Smith are recovered by ZYX. The fact that the profit would be recovered by ZYX does not necessarily mean that Smith is entitled to deduct the amount that he repaid.

Taxpayers, who had an apparent unrestricted right to the income in a prior year, qualify for the special relief provision in the year of repayment. (IRC §1341) However, since Smith realized the profit as the result of fraudulent/prohibited actions, he did not have a legitimate, unrestricted claim to the proceeds. Therefore, even though the profit would be recovered by ZYX, Smith is not allowed a deduction.

If these shares were held in Smith’s 401(k), Smith’s distributions from his 401(k) plan to repay ZYX are taxable income and are subject to an additional 10% penalty if made before age 59 ½. (IRC §72 (t) (1))

## **LOANS TO EXECUTIVES**

The Act prohibits new loans to executives and renewal of existing ones. (SOX § 402 (a) (1)) This section also prohibits the company from arranging loans for executives. This prohibition does not include loans such as home improvement loans, credit card balances

incurred in the ordinary course of business, or other loans that a company might, in the normal course of business, grant to customers. However, existing loans to executives are grandfathered as of the date of the Act, if there are no material modifications of the terms or extensions of the loans.

Assume that on December 31, 2003, Smith had a loan of \$25,000,000 from ZYX. Assume the loan was made before 2001 and was originally due on December 31, 2004. If Smith is unable to repay the loan in full by the date required by the Act, ZYX might forgive the loan.

Cancellation or forgiveness of a debt results in gross income to the debtor unless he is either in bankruptcy or insolvent. (IRC § 61 (a)) Special mandatory relief provisions apply to debt discharge income of bankrupt or insolvent taxpayers. (IRC § 108) Assuming Smith is not in bankruptcy or insolvent, debt forgiveness results in either a constructive dividend as defined by the IRS or ordinary income to Smith depending on whether he is a shareholder/employee or employee when the loan was forgiven. Smith owes tax of \$3,750,000 and the corporation loses the deduction resulting in additional corporate tax as well.<sup>3</sup>

## **OTHER TAX CONSEQUENCES**

In addition to the provisions of Sarbanes-Oxley, a CEO can still be subject to the usual fines and judgments for insider trading and securities fraud. For example, assuming an executive engages in insider trading, the SEC can prosecute the CEO and assess, under the RICO provision, up to triple the amount of damages suffered by other shareholders in addition to the return of any trading profits. (SOX § 304 (a) (2)) If the SEC finds that Smith violated federal or state statutes, he may be liable for antitrust triple damages, fines, penalties, and/or civil damages. (SOX § 807, § 1106) Smith may not deduct two-thirds of the antitrust damages paid or incurred. (IRC § 162 (g)) In addition, Smith may not deduct any fines and penalties paid. (IRC § 162 (f)) However, he may be able to deduct civil damages paid. (Comm. Tellier) Smith's legal fees paid to defend him may also be deductible if the payment was made to benefit the business and the expenses are ordinary and necessary. (IRC § 162 (a))

## **CONCLUSION**

The Sarbanes-Oxley Act of 2002 is intended to thwart financial scandals and increase the criminal penalties for violations of securities laws. Any financial benefits received by an executive during a period of financial misrepresentation are only short-lived because they must also be repaid to the corporation. Moreover, the executive may also face criminal and civil charges in addition to fines and penalties. An executive should be aware that there are severe tax consequences from repaying the income or profits to the corporation and for which the executive may not receive a deduction. In conclusion, violating the provisions of the Sarbanes-Oxley Act of 2002 not only brings harsh tax consequences, but also the demise of the executive's business reputation and a good portion of his or her personal wealth.

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<sup>3</sup> 15% \* \$25,000,000

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