

## Reduction or Cancellation of “Underwater” Note Results in Income to Employee

Employers often permit employees to purchase employer stock using a promissory note as payment. During the recent economic downturn, the stock value of many companies decreased, leaving some employees holding stock that was worth far less than the amount owed to their employers. In such cases, the employee and employer sometimes wish to “unwind” the stock-for-note arrangement or at least reduce the amount owed by the employee.

Treasury Regulations under Section 83 of the Internal Revenue Code (the “Code”) have long provided that the cancellation or reduction of the employee’s promissory note in such situations would result in taxable income to the employee.<sup>1</sup> However, certain taxpayers and advisors have taken the position that such cancellations or reductions were nontaxable either (i) under Section 108(e)(5) of the Code, which provides an exception to the recognition of debt forgiveness income for debt reductions that constitute “purchase price reductions” agreed to between the original buyer and seller of property, or (ii) under Section 108(a)(1)(B) of the Code, which provides an exception for debt reductions where the debtor is insolvent.

In Revenue Ruling 2004-37, issued on February 25, 2004, the IRS ruled that the Section 108(a)(1)(B) and (e)(5) exceptions do not apply to such situations,<sup>2</sup> and that an employee does recognize taxable income when his employer agrees to reduce the amount owed by the employee under a promissory note originally given by the employee to purchase employer stock.

In the fact pattern addressed by the ruling, Employer granted Employee a nonstatutory stock option to purchase 1,000 shares of Employer stock for \$75,000. Employee exercised the stock option at a time when the stock was worth \$100,000. Thus, Employee recognized \$25,000 of taxable income at the time the option was exercised. Employee paid the \$75,000 option exercise price with an interest-bearing, recourse promissory note. In a later year, the value of the stock decreased to \$50,000, and Employer and Employee agreed at that time to reduce the principal amount owed under the note to \$50,000.

On these facts, the IRS ruled that Employee recognized compensation income as a result of the note reduction. The amount of income recognized was equal to the \$25,000 reduction in the principal amount of the note.<sup>3</sup>

**The IRS also ruled that this amount was subject to employment taxes and income tax withholding because it constituted “wages.”**

### Other Modifications

The ruling indicates that other modifications to a promissory note used to acquire employer stock also “generally would result in compensation income” for the employee-debtor. The same would be true of modifications to notes used to acquire other property from an employer. According to the ruling, examples of such modifications include a reduction of the interest rate on the note or the conversion of a recourse note to a nonrecourse note. However, the ruling does not provide clear guidance as to how the amount of income should be determined in

such situations. In such cases, it may be necessary to determine whether the fair value of the note has decreased as a result of the modification.

### Nonemployee Notes

It is certain that the IRS will apply the principles of the ruling to reductions or cancellations of notes given by nonemployee service providers (i.e., consultants, directors and other independent contractors) to purchase the stock (or other property) of the company to which they provide services. In such cases, the independent contractor will recognize compensation income, but, as long as the independent contractor has never been an employee, the income amount will not be subject to employment taxes or income tax withholding.

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In some cases, the purchaser is a former employee of the company. In those cases, a careful analysis of the facts is required to determine whether the company is obligated for employment taxes and income tax withholding upon cancellation or reduction of a note used to purchase company stock.

### Public Company Officers and Directors

Section 402 of the Sarbanes-Oxley Act (“SOX”) now prohibits public companies from extending or maintaining credit in the form of a personal loan to an executive officer or director. While notes entered into prior to the July 30, 2002, effective date of SOX are grandfathered, it is unclear whether grandfathered notes can be cancelled or reduced without violating SOX Section 402. This legislation is therefore one more reason for public companies to exercise caution when dealing with underwater note arrangements and when considering whether to permit employees to pay for stock with a promissory note. See our *Cooley Alert* discussing “The Sarbanes-Oxley Act of 2002: Prohibition of Personal Loans to Executives” at [www.cooley.com/news/alerts.aspx?ID=000037610420](http://www.cooley.com/news/alerts.aspx?ID=000037610420).

### Alternatives for Dealing with Underwater Notes

The situation addressed by the ruling has long been a troublesome one for employers and employees (or other service providers). The ruling does nothing to alleviate such difficulties and confirms the adverse tax treatment expected by many advisors.

The alternatives for dealing with “underwater” notes like the one described in the ruling are limited and none of them is without either tax risk or significant financial consequences. The alternatives include:

- ▶ The parties could consider having the employee return the stock to the company in partial payment on the note. To the extent the note is paid by a return of stock that has depreciated (or at least has not appreciated) in value since its purchase date, no taxable income will result to the employee. In addition, the

employee will realize a capital loss on the stock to the extent the original note amount exceeds the fair market value of the stock. Determining whether and to what extent this capital loss can be used by the employee involves a detailed analysis of the employee’s personal tax situation.

- ▶ If the employee owns additional shares of employer stock, such additional shares could be used to repay some or all of the remaining note balance. If the employee has a tax basis in such shares that is less than their fair market value, the employee will recognize capital gain on such shares.
- ▶ If the note will not mature for a substantial period of time, the employer and employee could simply take no action in the hope that the stock recovers its value.
- ▶ If the note will mature soon, the parties could agree to extend the term of the note (with corresponding adjustments to the interest rate to reflect the new term and the applicable federal rate in effect on the date of the extension). The ruling suggests that such an extension may result in compensation income to the employee-debtor, but does not clarify how to compute the amount recognized. At least in some cases, the amount of income recognized should be less than the amount recognized if the note were cancelled in its entirety.
- ▶ Similarly, the parties could agree to reduce the interest rate on the note or to convert it to a nonrecourse note. Again, the ruling indicates that such actions generally will result in recognition of income, but does not clarify how to compute the amount recognized. At least in some cases, the amount of income recognized should be less than the amount recognized if the note were cancelled in its entirety.
- ▶ The employee could borrow the loan amount due from a bank or other third-party lender (for example, through a home equity loan) under a long-term arrangement, use the proceeds to repay the existing note to the employer and

hope that the stock eventually will recover its value.

- ▶ The employer could sell the note to an unrelated third party for its fair market value. While the tax results are not entirely clear, it is possible that an extension of the note’s term or other modifications agreed to by a third party may have more favorable tax consequences for the employee-debtor than those suggested by the ruling.
- ▶ If the parties decide to cancel the note during the same taxable year as it is issued, they may be able to “rescind” the original purchase with no tax consequence. The law on rescission is murky at best, so caution is advised.
- ▶ The employer could agree to take financial responsibility for some or all of the employee’s tax burden. Any tax amount paid by the employer for the employee will itself constitute wages subject to employment taxes and income tax withholding.
- ▶ The employer could agree to pay cash bonuses to the employee—either in a lump sum or over time—to help offset some of the burden of paying off the note. Such bonuses will be subject to employment taxes and income tax withholding. Keep in mind that conditioning bonus payments on repayment of the note might be considered an effective forgiveness of the note, requiring immediate income recognition. The same is true of agreements to forgive the note at some time in the future.

Before implementing any of these alternatives, it is important that employers and employees consult with their tax advisors.

### Planning Ahead

Over the last few years, many employers have reduced the number of stock-for-note arrangements they are willing to permit. In light of the ruling, we expect to see further reductions in the number of such arrangements. It is, of course, always important that the parties consider the possible

“downside” when entering into such arrangements. The ruling confirms that the downside includes adverse tax consequences. Thus, such arrangements should be entered into only if the employee is expected to have other resources with which to repay the note should the stock value decrease.

For advice on dealing with “underwater” notes, structuring future employee acquisitions of company stock or other aspects of your company’s compensation program, we encourage you to consult a member of the Cooley Tax or Compensation & Benefits Groups. Read these recent *Cooley Alerts* for further information:

- ▶ “Compensation Issues in the 2004 Proxy Season” [[www.cooley.com/news/alerts.aspx?ID=000038514520](http://www.cooley.com/news/alerts.aspx?ID=000038514520)]
- ▶ “The Changing Face of Equity Compensation” [[www.cooley.com/news/alerts.aspx?ID=000038007620](http://www.cooley.com/news/alerts.aspx?ID=000038007620)]. ■

## Notes

<sup>1</sup> See Treasury Regulations Section 1.83-4(c).

<sup>2</sup> The ruling’s conclusion that the Section 108(a)(1)(B) insolvency exception is “trumped” by Treasury Regulations Section 1.83-4(c) is somewhat surprising. Without express statutory authority, it is unclear how a regulation can override a statutory provision. Section 108(e)(5), by contrast, does include language that arguably provides the basis for an override by the regulation.

<sup>3</sup> As a technical matter, to determine the amount of income recognized by the employee, the ruling applied certain tax rules applicable to “original issue discount” obligations, comparing the “adjusted issue price” of the original note to the “issue price” of the note as modified. In the ruling’s fact pattern, these amounts were equal to the original and modified principal amounts of the note.