Employee Was Properly Taxed on the Value of Stock When Option Was Exercised

BY ANNE S. LEWIS, ESQ.

The value of RealNetworks shares was properly determined on the date an employee’s stock options were exercised, the U.S. Fifth Circuit Court of Appeals has affirmed. Accordingly, the employee was not entitled to a refund of taxes paid on the income from the exercise—the difference between the fair market value of the shares and the exercise price paid on that date [Cidale v. U.S., No. 05-51372 (5th CA, 1-9-07)].

Ricardo Cidale exercised stock options granted by his employer RealNetworks, in January 2000 by borrowing funds from his broker, Salomon Smith Barney. Cidale repaid the loan when he liquidated his interest in the stock in September 2000.

Cidale argued that income taxes should have been assessed when the loan was repaid rather than on the date he exercised the stock options. Needless to say, the court explained, the stock was worth less, and the resulting tax was less, if the taxable transfer date was in September rather than January.

The court rejected Cidale’s argument, saying that the shares were transferred and substantially vested in Cidale on the date of exercise. He acquired beneficial ownership of the shares on that date and had the right to receive any dividends and vote the stock. In addition, his capital was at risk under the terms of the margin agreement. Smith Barney could sell the stock as collateral to pay off Cidale’s loan, but Cidale remained personally liable for any deficiency in the event that proceeds for the shares did not repay the loan.

Tax Court Looks at Date Beneficial Ownership Interest Passes
In another case involving the taxation of stock options, Edward Walter disputed the date of exercise of stock options granted to him by his employer, Primus Knowledge Solutions, Inc. The IRS argued that he exercised the options on the date he faxed the notice required under the company stock option plan, while Walter argued that he exercised the options on the date a check was delivered from his broker to Primus in full payment of the exercise price (four days later).

The Tax Court agreed with the IRS, saying that the shares were transferred to Walter on the date he gave the required notice. As of that date, Primus treated Walter as having met all the requirements for exercising his options under its plan and became obligated to issue the shares. Walter, in turn, became obligated to pay for them, either by selling them or by advancing funds on margin. He incurred the risk of a beneficial owner that the value of his shares would decline and could dispose of them as he saw fit. In fact, after first giving an order to sell, he changed his mind and used at least some of the shares as collateral for funds he borrowed from his broker to pay withholding taxes due on the exercise of his options [Walter v. Commissioner, No. 8321-05 (T.C. Memo. 2007-2, 1-3-07)].

IRS Says Smartcards, Debit, or Credit Cards May Be Used for Transportation Fringes

BY ANNE S. LEWIS, ESQ.

The IRS has issued guidance describing situations where employer-provided transportation benefits provided through smartcards, debit or credit cards, or other electronic media are excluded from gross income [Rev. Rul. 2006-57; 2006-47 IRB 911].

Excluded From Income

Smartcards. The fare media value stored on the smartcards is useable only as fare media for the applicable transit system. Thus, the smartcard qualifies as a transit system voucher. In addition, the amount allocated to each employee’s smartcard is within the limit for exclusion.

Terminal-restricted debit cards. The terminal-restricted debit card qualifies as a transit system voucher because it can be used only at merchant terminals at points of sale at which only fare media for the applicable transit system can be purchased. In addition, the amount allocated to each employee’s debit card each month is within the limit for exclusion.

MCC-restricted debit cards. The MCC (merchant category code) restricted debit card does not qualify as a transit system voucher because it is possible that an MCC-restricted debit card may be used to purchase items other than transit passes. However, where a voucher exchangeable only for fare media is not readily available, a bona fide reimbursement arrangement for transit passes may be established by facts and circumstances.

For example: (1) with respect to expenses paid using the card, the employer receives periodic statements providing information on the purchases made with...
the card, including the identity of the seller, and the date and amount of the transactions; (2) for the first month an employee uses the card, he/she must certify that the card was used only to purchase fare media; (3) the employer does not require monthly certifications with respect to recurring items if the item described in the periodic statement matches with respect to seller and time period items that have previously been substantiated as transit pass expenses; (4) the employer requires annual recertification from each employee that the card was used only to purchase fare media; (5) prior to remitting an amount as reimbursement for transit pass expenses for an employee, the employer examines the periodic statements describing card transactions in combination with employee certifications; and (6) the employer provides funds to be electronically allocated to the cards only as reimbursements for substantiated transit pass expenses incurred and substantiated in this fashion.

Not Excluded From Income

**MCC-restricted debit cards.** Where the employer provides the cards in advance, requiring its employees to certify that they will use them exclusively to purchase transit passes, the arrangement does not constitute a bona fide reimbursement arrangement (see above). The arrangement provides for advances rather than reimbursements and relies solely on employee certifications provided before the expense is incurred. Those certifications, standing alone, do not provide the substantiation of expenses incurred necessary for there to be a bona fide reimbursement arrangement.

Effective Date

The ruling is effective January 1, 2008, but may be relied on prior to that date. Note that in earlier guidance, the IRS said that if a debit card qualifies as a voucher, then cash reimbursement for transit pass expenses is precluded if a debit card is “readily available.” The IRS intends to issue guidance clarifying when debit cards are considered to be “readily available.” Until then, the IRS will not challenge cash reimbursement arrangements where the only available voucher is a terminal-restricted debit card.