This article examines the implications of Internal Revenue Service Chief Counsel Advice memo CCA 200926001. The memo advised that the service can seize and sell executive stock options held by a taxpayer regardless of restrictions on the transferability of the options. Although the memo cannot be used or cited as precedent, it provides insight into IRS’s enforcement policy.

IRS Right to Levy: Seizing and Selling Nontransferrable Options?

By James B. Bristol

The Internal Revenue Service has adopted the position that it can seize and sell stock options under its broad rights of levy. An internal legal memorandum from the IRS Chief Counsel, CCA 200926001, states that the IRS has authority under Section 6334 of the Internal Revenue Code to seize stock options held by the taxpayer and to sell the options to a third party. Under the terms of the employer-provided stock options, the taxpayer could not have transferred or sold the options except in very limited circumstances. Essentially, the Chief Counsel’s Advice was that the IRS had rights of transfer greater than the rights held by the taxpayer.

IRS Right to Levy. The executive’s stock options were seized through IRS Form 668-A, Notice of Levy on Wages, Salary and Other Income. Section 6331 of the tax code allows the IRS to levy on property or property rights without regard to any other law of the United States, including any other provision of the code. The taxpayer held both nonqualified options and incentive stock options (ISOs). The terms of the nonqualified options included contractual restrictions on transfer. The ISOs additionally included restrictions on transfer that are mandated by Section 422 of the code. The CCA concludes that Section 6331 of the code supersedes or overrides contractual and statutory restrictions.

As further rationale, the CCA makes an analogy to the IRS’s ability to levy on retirement benefits held in an ERISA-covered retirement plan. As required by Section 401(a)(2) of the code and Section 413(a) of ERISA, retirement plan assets can only be used to provide ben-
enefits to participants and their beneficiaries and cannot be alienated in favor of creditors. However, as provided in Treasury regulations and confirmed in federal court decisions, the IRS’s rights of levy override those restrictions on alienation.

Disposition of Nontransferable Options. The ability of the IRS to take ownership of the stock options under Section 6331 of the code is well-supported in the CCA. The IRS essentially stands in the shoes of the taxpayer and can enjoy the property rights held by the taxpayer. However, the authorities cited by the Chief Counsel do not support the IRS selling nontransferable stock options to a third party. The CCA includes a conclusory statement that the options can be sold in spite of the restrictions on transfer under the procedures of Section 6335 of the code. Section 6335 merely outlines procedures required for giving the taxpayer notice of seizure and sale of property.

This assertion is troubling, if interpreted broadly. Rather than standing in the shoes of the taxpayer, the IRS might be claiming that Sections 6331 and 6335 provide it with greater property rights than had been granted to the taxpayer by his employer. Restrictions on transfer are found in all compensatory stock option programs, many of which are legally required. Transfer restrictions serve the following purposes:

1. SEC Registration. Compensatory stock options generally are subject to registration under federal and state securities laws. Securities and Exchange Commission Rule 701 provides an exemption from registration for options that are granted to employees (and service providers) and cannot be transferred to a third party. There is a narrow exception for transfers of nonqualified stock options to family members in connection with estate planning. Publicly traded companies cannot rely on Rule 701 but typically rely on Form S-8 to register stock incentive programs that include identical transfer restrictions.

2. Incentive Stock Options. ISOs have additional restrictions under Section 422 of the code. A transfer of an ISO may only occur in the event of death or divorce.

3. Corporate Governance and Objectives. The ability to sell stock options or make transfers to third parties would defeat the legitimate compensatory objectives of providing stock options and similar incentives. One such objective is to encourage long-term stock ownership by employees to align their financial interests with shareholder interests.

Relatively few companies have stock options traded on an active market. Perhaps no company has a market for trading compensatory options awarded to employees. Thus, the IRS position may have little practical impact in the stock option world as there would be limited opportunities for selling options seized under Section 6331.

The facts in the CCA indicate that the employer was in the midst of being acquired. One would expect that the acquisition provided the IRS with an opportunity to “sell” their newly seized stock options to the acquirer. Stock options are often purchased for cash in a corporate merger or acquisition, based on the difference between the option exercise price and the value paid for the stock in the acquisition. Such a purchase is usually treated as a cancellation of the option, not a transfer of the option to another party.

Tax Treatment of Seizure and Sale. The collateral tax consequences on the seizure and sale of the option are not discussed in the CCA and are uncertain. The transfer of the option from the taxpayer to the IRS may or may not trigger tax. In Revenue Ruling 2002-22, 2002-19 I.R.B. 849 (May 13, 2002), the IRS ruled that transferring stock options in a divorce was not a taxable event. However, this ruling relies on Section 1041 of the code, which provides for nontaxation of property transferred incident to a divorce. Potentially, the seizure of the option by the IRS could be characterized as a taxable disposition of the option by the taxpayer for value.

Déjà vu All Over Again? This is not the first foray by the IRS into the territory of finding greater rights in seized property than were held by the taxpayer. In United States v. Craft, 535 U.S. 274 (2002), the Supreme Court agreed with the IRS position that a federal tax lien attached to a taxpayer’s interest in marital property, in spite of Michigan law to the contrary. The property was held in a tenancy by the entirety. Neither spouse could convey or encumber the property without the consent of the other. The Court recognized that state law prevented the taxpayer from selling the property to satisfy his tax obligation. However, the Court reasoned that the taxpayer’s rights were sufficient to constitute “property” for purposes of a federal tax lien that encumbered the property. The Court was aware that it was allowing the IRS greater property rights than were held by the taxpayer.

Conclusion. If the opinion rendered in the CCA is simply that the IRS has the ability to receive cash in exchange for stock options it seizes in a corporate acquisition, like all other option holders, this position will be acceptable to most practitioners. Time will tell, however, if the Chief Counsel’s opinion is that the IRS can acquire property rights in stock options that are greater than those held by the taxpayer.