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Fraudulent Value of Stock Options: No Refunds Allowed

The U.S. Court of Federal Claims has denied a taxpayer's refund based on the theory that he was issued a fraudulent Form W-2 by his employer, WorldCom. The W-2 reflected the taxpayer's exercise of nonqualified stock options for WorldCom stock, which, after fraudulent accounting financial statements were revealed, was actually worth much less than what was reflected on the W-2.

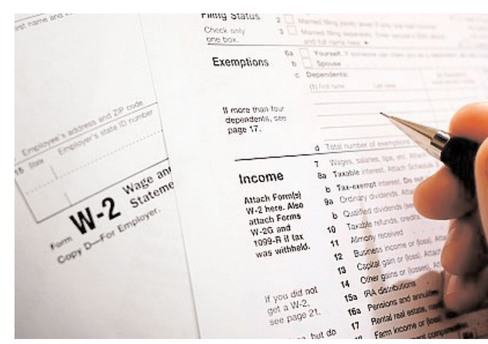
Generally, when an employee receives a nonqualified stock option without a readily ascertainable fair market value, he is taxed when he exercises the option and the shares are transferred to (and vested in) the employee.

In the case, an employee of WorldCom exercised nonqualified stock options for 90,300 shares of WorldCom stock in January 2000. He paid $1,922,344 in exercise costs and taxes. The employee began selling his stock two months later and had disposed of it all by January 2001. When this employee received his 2000 WorldCom Form W-2, it stated he had been paid $2,690,415 (which reflected, in part, the exercise of the stock options).

In June 2002, WorldCom announced a major restatement of its financials and revealed that from 2000 to 2001 the organization had been reporting profits when it actually was incurring losses. When WorldCom's operations and finances began to surface, its stock price plummeted, falling more than 90% and erasing more than $2 billion in shareholder value.

The employee subsequently filed a refund claim based on the theory that on the date he purchased the WorldCom stock it was actually worth only $13, rather than $42. He claimed that the 2000 W-2 was incorrect and inflated because WorldCom had been inflating the alleged value of its stock through fraudulent financial statements for years. He claimed a refund of $1,091,324 in income tax, plus interest and penalties, along with a refund of $38,768 in Medicare taxes. This refund was denied by the IRS, but he tried to seek relief in court.

The Court of Federal Claims rejected the employee's refund suit as lacking legal merit. He exercised stock options to purchase the WorldCom stock that had a known market value. The market



value was the basis for his tax liability, regardless of the later misrepresentations and fraud by the company.

The fact that the stock was purchased from WorldCom under an employee stock option plan didn't affect the valuation. The Court reasoned that the stock had a market value that generally is the "fair" valuation for tax assessment purposes. The Court rejected the employee's allegation that he never actually "received" the stock, and thus the date of the option exercise was the valuation date.

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