

Client Alert

Latham & Watkins
Tax Department

IRS Releases 409A Resolution Program for Discounted Stock Options and SARs Exercised in 2006 – Urgent Action Required for Interested Employers

On February 8, 2007, the Internal Revenue Service (IRS) announced a compliance resolution program (Program), Announcement 2007-18, that permits employers to pay the additional taxes arising under Section 409A of the Internal Revenue Code (Section 409A) due to the exercise of certain discounted stock options and stock appreciation rights (SARs) by employees during 2006. It is not clear whether employers will find the Program's terms beneficial enough to elect to participate; however, it is critical that employers with exercises of discounted stock options and SARs in 2006 review the terms of the Program. As discussed below, in order to participate, an employer must notify the IRS by February 28, 2007.

Background

Section 409A imposes sweeping new rules for nonqualified deferred compensation arrangements. Guidance from the Department of Treasury has provided that stock options and SARs generally are exempt from Section 409A if (i) the exercise price of the stock option or SAR equals or exceeds the fair market value of the underlying stock on the date of grant and (ii) the stock option or SAR has no other feature

for the deferral of compensation.¹ In recent months, the IRS has become aware of numerous instances in which stock options or SARs were issued with an exercise price less than the fair market value of the underlying stock on the date of grant because of discrepancies between the purported grant date and the actual grant date (e.g., backdated options). The exercises in 2006 of discounted stock options or SARs generally are subject to Section 409A; and, unless affirmative steps were taken before exercise to avoid a violation of Section 409A, such exercises resulted in adverse federal income tax consequences under Section 409A for the employee (*i.e.*, an additional 20 percent income tax on the amounts required to be included in income and interest on unpaid taxes) and reporting requirements for the employer.

Program Terms

The Program provides relief for employees (other than employees subject to the disclosure requirements of Section 16(a) of the Securities Exchange Act of 1934) who are subject to the adverse federal income tax consequences under Section 409A because of the exercise of discounted

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stock options or SARs during 2006. In order to participate in the Program, the employer must:

- i) submit to the IRS by February 28, 2007 a notice of the employer's intent to participate in the Program;
- ii) provide a notice to all affected employees no later than 15 days after the employer submits the notice to the IRS, informing such employees of the employer's intent to participate (employee notices);
- iii) provide a second notice to the IRS, no later than 15 days after the employer submits the first notice to the IRS, stating the number of employees to whom the employee notices were provided; and
- iv) make a further submission of information, including payment, to the IRS by June 30, 2007 (further submission).

The further submission must include detailed information about the affected employees, the discounted stock options and SARs, the exercise of such discounted stock options and SARs, and the specifics on the Section 409A tax calculation. The further submission must be accompanied by the remittance of all Section 409A taxes due (*i.e.*, the full amount of the additional tax liability of the employee under Section 409A that results from the exercise of discounted stock options and SARs).

The Program describes how the Section 409A taxes are to be calculated. For purposes of the Program, the 20 percent additional tax equals 20 percent of the excess of the fair market value of the stock on the date of exercise over the sum of the exercise price. The amount of underpayment interest equals the amount of interest at the underpayment rate² plus 1 percent on the underpayment of federal income tax that would have occurred had the amount deferred under the vested stock option or SAR been includible in the employee's gross income as of December

31, 2005. For this purpose, the amount deferred as of December 31, 2005 equals the excess of the fair market value of the underlying stock on December 31, 2005 over the sum of the exercise price. Employers must calculate the underpayment based on a tax rate of 35 percent, which is the highest marginal federal income tax rate for 2005, and treat the underpayment as due on April 17, 2006, with the interest running from such date through the earlier of April 17, 2007 or the date the further submission is sent, with payment, to the IRS. For payments sent to the IRS after April 17, 2007, the amount required to be submitted is increased by the underpayment interest rate applied to the amount that would otherwise be due on April 17, 2007 through the date the further submission, with payment, is sent to the IRS.

In addition, no later than July 15, 2007, the employer must provide a further notice to all employees who received employee notices (and any additional employees that are listed in the further submission to the IRS), informing them that the employer has made a further submission and payment under the Program to the IRS (or alternatively, that the employer has not made a further submission and payment under the Program to the IRS). The employer retains the right to withdraw from participation in the Program or modify a further submission on or before June 30, 2007.

Announcement 2007-18 provides that Section 409A taxes paid by an employer will be treated as additional compensation income to the employee for 2007 and such amounts also will be considered wages for purposes of FICA, FUTA and federal income tax withholding for the 2007 tax year. As a result, an employer must consider whether to make additional "gross-up" payments to affected employees if the employer intends to make the employees fully whole for the taxes imposed under Section 409A.

Employers with exercises of discounted stock options or SARs in 2006 that give rise to Section 409A taxes are encouraged to call Joe Yaffe of our Silicon Valley office at +1-650-463-4676 or any of the attorneys listed on the final page of this *Alert* to discuss the terms of the Program and determine whether to notify the IRS of their intent to participate in the Program.

Endnotes

¹ See our previous *Client Alerts* for additional information regarding the scope of Section 409A and its application to stock options and SARs (e.g., Alert No. 411, *Legislation Contains Significant Deferred Compensation Changes*, October 12, 2004 and Alert No. 492, *Proposed Regulations under Section 409A – Important Issues for Stock Options*, November 18, 2005). The Latham & Watkins *Client Alerts* related to Section 409A may be accessed via the following link: <http://www.lw.com/resource/Publications/ClientAlerts>.

² The underpayment rate is the sum of (i) the federal short-term rate and (ii) three percentage points.

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