
Legal Updates & News

Legal Updates

Immediate Action Required: IRS Offers Limited Relief for Backdated Stock Options

February 2007

On February 8, 2007, the IRS issued Announcement 2007-18 (the "Announcement") outlining the terms of the "Compliance Resolution Program for Employees Other than Corporate Insiders for Additional 2006 Taxes Arising Under § 409A due to the Exercise of Stock Rights" (the "Program"). While this less-than-succinct appellation readily identifies the purpose and scope of the Program, the requirements for securing relief under it are rather more detailed, as discussed below.

In brief, the Program allows employers that undertake the corrective actions specified in Announcement 2007-18 to effectively assume responsibility for the additional tax imposed by Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), that the optionholders would otherwise bear as a result of their exercise in 2006 of back-dated or discounted stock options.

There is an extensive array of notice requirements associated with the Program and the window of eligibility for electing to participate in the program is extremely small. *Employers choosing to participate in the Program will be required to notify the IRS of their intentions no later than February 28, 2007.* Please refer to the table below for a summary of the relevant deadlines associated with participation in the Program.

Section 409A and Stock Options

As discussed in our prior *Legal Updates* dealing with Section 409A,^[1] stock options and stock appreciation rights (collectively referred to as "stock rights" in Section 409A parlance) are not generally regarded as deferred compensation arrangements *unless* they are granted with an exercise price that is less than the fair market value of the underlying shares on the date of grant (*i.e.*, as long as they are not granted at a discount, either intentionally or inadvertently). Stock options that were granted at a discount are treated as deferred compensation arrangements by Section 409A with the deferred compensation element comprising the spread between the fair market value of the underlying shares and the specified exercise price.^[2] It is highly unlikely that a typical stock option will comply with Section 409A's requirements – particularly its mandate for a fixed exercise date – absent a purposeful attempt by the granting employer. As a result, employees who exercised discounted stock options in 2006 are likely to have incurred not only ordinary income taxes on the proceeds of the exercise but also the additional 20% tax imposed by Section 409A and related interest on the deferred amount. Now that the tax reporting and withholding requirements imposed by Section 409A are in effect,^[3] this issue has become pressing for individual optionholders as they contemplate their 2006 individual income tax returns.

Summary of Program Requirements

Since it became obvious that stock option back-dating presented issues under Section 409A as well as under the securities laws and accounting standards, the IRS entertained various requests for relief from the additional taxes imposed by Section 409A, particularly for non-executive employees who did not play a role in back-dating their own stock options. After meeting with industry groups

Related Practices:

- [Corporate](#)
- [Employee Benefits and Executive Compensation](#)
- [Employment and Labor](#)
- [Tax](#)

during the fall of 2006, the IRS developed the limited corrective alternative outlined in Announcement 2007-18.

Scope of the Program

The Program applies only to the additional Section 409A taxes incurred in connection with the exercise of a stock option in 2006. For this purpose, both the 20% additional tax imposed by Section 409A(a)(1)(B)(i)(II) and the interest imposed by Section 409A(a)(1)(B)(i)(I) are considered to be "Section 409A taxes."^[4] However, the Program does *not* alter an employer's tax reporting and withholding requirements associated with the ordinary income generated by an option exercise, nor does it excuse employees from their obligation to report such income on their individual tax returns and to pay the applicable taxes. Further, the Program does not address potential issues relating to the failure of purported incentive stock options to qualify as such, and it does not impact the application of Section 162(m) to the stock options at issue.

Eligibility

In general, the Program is available for employers that granted discounted stock options that were exercised in 2006 by non-executive employees. Stock options exercised by any employee who is or was subject to the disclosure requirements imposed by Section 16(a) of the Securities Exchange Act of 1934 (whether at the date on which the options were granted or the date when the employer provides notice to the IRS of its intention to participate in the Program) are *not* eligible for correction under the Program.

Notice Requirements

Initial Notice by Employer to IRS. No later than February 28, 2007, an employer must notify the IRS of its intention to participate in the Program. The employer must include a specified statement of intent, executed under penalty of perjury, identifying itself, a contact person, and a certification that it either is not under IRS investigation or that it is under IRS investigation and is submitting the notice to the examining agent.^[5]

Notice by Employer to Affected Employees. Within 15 days after submitting its initial notice to the IRS, the employer must provide a notice to all employees that it reasonably anticipates may be affected by its participation in the Program, including the following information:

- The employer has elected to participate in the Program; the Program must be specifically referenced by name.
- The employer intends to provide further information to employees no later than July 15, 2007, certifying either that it has made a further submission to the IRS that it believes satisfies the requirements of the Program or that no such submission has been made.
- Participation in the Program may impact the employees' Federal income tax obligations relating solely to Section 409A but does not affect their obligation to report and pay applicable income taxes on the proceeds of their option exercises or the employer's obligation to report such proceeds on Form W-2.

The notice may include additional information that is consistent with the foregoing required content. Notices must be provided directly to affected employees but can be provided electronically.^[6] If an employer subsequently determines that the exercise of a stock option by an additional employee is eligible for correction under the Program, the employer may include the additional employee in a "further submission" to the IRS without providing the foregoing notice as long as the other notice requirements set forth in the Program are satisfied.

Second Notice by Employer to IRS. Within 15 days following the initial notice to the IRS, the employer must provide a separate notice to the IRS specifying the number of employees to whom the employee notice was provided.

Further Submissions by Employer to the IRS. A participating employer must make a "further submission" and tax payment to the IRS on or before June 30, 2007. A further submission provides additional detailed information regarding the employees covered by the submission. An employer's failure to make a further submission will preclude employee access to the relief provided by the Program.

A further submission under the Program will consist of the following, submitted under penalty of perjury:

- The employer's name and employer identification number;
- A list of the employees for whom the employer is remitting the Section 409A taxes due;
- For each listed employee, specific information about the stock right at issue, including (1) the date of exercise, (2) the exercise price, (3) the fair market value of the shares on the date of exercise, and (4) the number of shares purchased (or, for stock appreciation rights, the number of shares used to calculate the payment made); and
- For each identified stock right, the amount of the Section 409A taxes remitted and the manner in which they were calculated.

An employer must also certify the following to the IRS:

- The notice to affected employees was provided within 15 days following the employer's initial submission to the IRS.
- The employer made reasonable, good-faith efforts to identify all option exercises by each listed employee during 2006 that were subject to additional taxes under Section 409A, based on a reasonable, good-faith interpretation of the applicable guidance and has accurately identified all such exercises and accurately calculated and paid the applicable additional taxes.
- Upon written request, the employer will disclose the relevant portions of its submissions to the IRS as necessary to enable employees to complete their 2006 individual Federal tax returns and/or to respond to IRS inquiries, examinations, or litigation involving the exercise of the options.

Final Employee Notice. No later than July 15, 2007, the employer must provide an additional notice to affected employees certifying the following information:

- The employer has made a further submission under the Program (specifically referenced) identifying the employees and remitting their Section 409A taxes or indicating the employer's conclusion that no such taxes were due and that to the best of the employer's knowledge, it has satisfied the Program's requirements; or
- The employer has not made a further submission (specifically referenced), and the employees are therefore liable for any applicable Section 409A taxes.

Calculation and Payment of Section 409A Taxes

Remittance of Taxes

No later than June 30, 2007, a participating employer must remit the full amount of the Section 409A taxes relating to the employees disclosed in the further submission. This amount will include not only the 20% additional tax but also the interest, calculated in the manner described below. An employer will be deemed to have remitted the appropriate amount if it remits substantially all of the Section 409A tax liability based on a reasonable, good-faith interpretation of the applicable guidance (*i.e.*, the proposed Section 409A regulations and related IRS administrative guidance). If the IRS determines that an employer has failed to remit substantially all of the applicable taxes, neither the employer nor the affected employees will be entitled to relief under the Program.

Calculation of the Interest on Deferred Amounts

Of some importance, the IRS has clarified the approach to be used for determining the interest imposed by Section 409A. Prior IRS guidance did not specifically address this issue.

The amount of the interest equals the amount of interest on the deferred amounts at the applicable Federal underpayment rate plus one percent on the underpayment of Federal income tax that would have occurred if the portion of the deferred amount that was vested on December 31, 2005 had been includible in income as of that date.^[7] The "deferred amount" as of December 31, 2005 equals the excess of the fair market value of the underlying stock as of December 31, 2005 over the sum of the exercise price and any other consideration paid by the employee. Employers are required to calculate the underpayment based on the highest marginal Federal tax rate in effect for 2005 (*i.e.*, 35%). The underpayment is treated as due on April 17, 2006, and interest runs from that date through the earlier of April 17, 2007, or the date of the employer's further submission and tax remittance under the Program.

If the employer remits the tax payment after April 17, 2007 (but before June 30, 2007), the amount required to be submitted will increase based on the Federal underpayment rate from that date through the date of remittance.

Right to Withdraw Submission

An employer may withdraw its submission at any time prior to June 30, 2007, provided the required notices of the withdrawal are provided to affected employees. An employer may also modify its submission prior to June 30, 2007 (with appropriate notice to affected employees), but any such modifications made after April 17, 2007, that involve the payment of additional Section 409A taxes will trigger a further adjustment in the amount due using the methodology described above. If an employer withdraws its submission on or before June 30, 2007, it is entitled to a refund of any amounts paid (without interest). If a further submission reduces the amount of Section 409A taxes due, the employer may request a return of the excess amount as long as the modification is submitted prior to June 30, 2007. Thereafter, the excess amount may be returned only if the employer presents evidence that the employee(s) at issue paid the taxes in full.

Tax Effects to Employees

If an employee's employer fully complies with the Program's requirements, the employee will not be required to pay the additional Section 409A taxes on his or her 2006 individual Federal income tax return. If an employee's option exercise was not disclosed in the employer's further submission, this relief is not available, and the employee will be required to report the exercise on his or her individual income tax return and remit the appropriate additional Section 409A taxes. The Announcement does not excuse an employee from reporting and paying ordinary income taxes on the proceeds of his or her option exercise.

The Announcement provides limited relief for employees who, in reliance on a notice received from their employer, fail to report and remit the additional Section 409A taxes on their 2006 individual returns: such employees are deemed to have had reasonable cause for their underpayments and will not be subject to penalties under Section 6654 for any estimated tax underpayment attributable to such a failure. For employees who request an extension of time to file after receiving a notice from their employer and subsequently file a timely return under the extension after learning that they are not eligible for the relief offered by the Announcement, no penalties under Sections 6651(a)(2) or 6654 for the failure to timely pay taxes will be assessed, provided the taxes are paid with their filed 2006 individual return.

An employer's payment of Section 409A taxes on behalf of its affected employees will generate further ordinary income for the employees in 2007 and must be reported as such.^[8] The employer must certify under penalty of perjury that it is treating the tax payments as additional taxable compensation to the affected employees. If an employer fails to adhere to this requirement, the impacted employees will not be eligible for relief under the Program.

While covering Section 409A taxes should generate some amount of goodwill among affected employees, saddling them with an additional tax liability resulting from the payment – which would be withheld from other wages paid to them – will almost certainly undercut that effect. As a result, many employers are likely to provide additional gross-up payments to cover the additional tax liability.

Tax Reporting Issues

If an employer fully complies with the requirements set forth in the Announcement, it is not required to report the Section 409A inclusion amount on the employees' Forms W-2 for 2006. If the employer has previously provided a Form W-2 containing this information, it may submit a W-2c which omits the information. No relief is provided for reporting relating to option exercises that were not disclosed in the employer's further submission. The Program does not relieve an employer of its obligation to report the income generated by the exercise of the options at issue or to withhold the appropriate amounts of ordinary income tax.

Failure to Comply

If an employer is determined to have made false statements in connection with its submissions under the Program, no relief will be available to affected employees except with respect to the penalties discussed above. However, the Commissioner of Internal Revenue possesses sole discretion to determine that an employer substantially complied with the Announcement such that some or all of the identified employees are entitled to relief.

State Tax Issues

The IRS emphasizes that the Announcement does not excuse employers from compliance with any tax reporting or payment requirements imposed by applicable state or local law.

Further Information

The IRS reserves the right to request additional information from employers participating in the Program and to audit Federal tax returns or seek unpaid taxes or assess penalties and interest (except as otherwise provided in the Announcement).

Conclusions

Announcement 2007-18 offers welcome – if limited – guidance for employers attempting to at least partially mitigate the consequences of stock option back-dating for non-executive employees. Further, the Announcement clarifies the methodology for use in computing interest assessed under Section 409A. Employers may still opt to forego the relief offered under the Program in favor of direct gross-up payments to affected employees, but they now have a choice of remedial alternatives that did not exist previously.

Announcement 2007-18 Timeline	
Deadline	Actions Required
February 28, 2007	<ul style="list-style-type: none"> • Deadline for submission of initial notice to IRS of intent to participate
March 15, 2007	<ul style="list-style-type: none"> • Latest date for providing notice to affected employees of initial submission to IRS • Latest date for submission of further IRS notice
April 17, 2007	<ul style="list-style-type: none"> • Individual income tax return deadline • Additional interest accrues for Section 409A tax payments made after this date
June 30, 2007	<ul style="list-style-type: none"> • Deadline for “further submissions” • Deadline for Section 409A tax payments
July 15, 2007	<ul style="list-style-type: none"> • Final deadline for notifying employees regarding eligibility for relief under Program

Footnotes:

[1] For additional discussion about Section 409A, please refer to our prior *Legal Updates* entitled: [Deferred Compensation Plans to Undergo Major Changes Under American Jobs Creation Act of 2004](#); [Deferred Compensation Update: IRS Issues Initial Guidance Notice 2005-1](#); and [Deferred Compensation Update: IRS Issues Proposed Regulations Under Code Section 409A](#). Additional analysis of more specialized Section 409A issues can be found in the following *Legal Updates*: [Proposed Code Section 409A Regulations Prompt Reconsideration of Stock Valuations for Equity Compensation Programs](#); [IRS Notice 2006-4 Provides Interim Relief from Section 409A Valuation Requirements for Stock Options](#); [Upsetting the Apple Cart: New Deferred Compensation Rules Endanger Employment Agreements and Severance Plans](#); [Tax Issues Arising Out of Stock Options Back-Dating Investigations](#); [IRS Extends Section 409A Compliance Date for Non-Qualified Deferred Compensation Arrangements](#); and [All Good Things Must Come to an End – Section 409A Tax Reporting and Withholding Requirements Are Now Effective](#).

[2] Stock options that were back-dated in order to set an exercise price for the option that was lower than the fair market value of the underlying stock on the actual date of grant will generally be subject to Section 409A to the extent they were (i) granted after October 3, 2004, (ii) granted before October 4, 2004, but not vested as of December 31, 2004, or (iii) “materially modified” after October 3, 2004.

[3] See [All Good Things Must Come to an End – Section 409A Tax Reporting and Withholding Requirements Are Now Effective.](#)

[4] The Announcement indicates that for Section 409A violations involving stock rights, the Program will limit the application of Section 409A's plan aggregation rules to amounts deferred under stock rights subject to Section 409A that are held by the employees with respect to whom the violations occurred. In simple terms, this means that if a non-executive's unexercised discounted stock option can be amended or exchanged for a stock option that raises the exercise price to an amount that is no less than the fair market value of the underlying stock on the original option's grant date, it will not be aggregated with any discounted stock options that were exercised in 2006 for purposes of determining the amount of the Section 409A taxes that must be remitted under the Program. In any event, the Announcement clarifies that the inclusion of income relating to a non-compliant stock option held by non-executive employees under Section 409A will not occur prior to the 2007 tax year.

[5] A Form 2848 (Power of Attorney) may also be necessary if the IRS is to communicate with the employer's authorized representative.

[6] An electronic distribution method consistent with the IRS's guidance for communications relating to qualified retirement plans should satisfy this requirement. See "Use of Electronic Media for Providing Employee Benefit Notices and Making Employee Benefit Elections and Consents," 71 Fed. Reg. 61,877 (Oct. 20, 2006) (summarizing final regulatory provisions applicable to electronic communications relating to qualified retirement plans and IRAs).

[7] The Federal underpayment rate is announced on a quarterly basis by the IRS. Per IRS Revenue Ruling 2006-63, the federal underpayment rate for the first quarter of 2007 and the first fifteen days of April 2007 is 8%.

[8] The Announcement makes it clear that the tax payments will constitute "wages" for purposes of employment tax reporting and withholding during the year of payment.