IRS Offers 'Compliance Resolution Program' for 2006 Exercises of Discounted Stock Options

The IRS has just announced a compliance resolution program (Announcement 2007-18) aimed at 2006 exercises of stock options granted at a discount. Discounted options are subject to Section 409A of the Internal Revenue Code – the "nonqualified deferred compensation" rules – and if exercised in 2006 resulted in liability for an additional 20% tax plus a further interest-based tax. The new program gives employers an opportunity to pay these taxes on behalf of most affected employees. (Public-company officers subject to Section 16 of the Securities Exchange Act of 1934 are *not* eligible.)

The compliance deadlines laid out in the Announcement are tight and the benefits of participation are very limited. Simplified Form W-2 reporting and some employee-relations benefits are the principal advantages, but those advantages may be outweighed by a number of considerations, including a higher tax rate on the interest-based portion of the payment and the fact that participation in the program will effectively make it impossible to contest whether affected options are, in fact, subject to Section 409A.

Employers that have already properly reported Section 409A amounts on Forms W-2 for 2006 may prefer simply to pay additional cash compensation to affected employees to help them meet their tax obligations in April.

If an employer elects to participate in the program:

- Affected employees will not have to pay the 409A sanctions (the 20% and interest-based additional taxes) because the employer will pay these amounts.
- However, the employee *will* have to treat as additional taxable income (for 2007) the taxes paid by the employer.
- The taxable income associated with a 2006 option exercise is still reportable on the Form W-2 for 2006 (and the employee would be liable for regular income tax on that amount), but no 409A inclusion (Code "Z") would be required to be reported in Box 12.
- To initiate participation in the program, the employer must notify the IRS *by February 28, 2007*, using prescribed language. Not more than 15 days after this first notice, the employer must notify affected employees and also tell the IRS how many employees are affected. Then, not later than June 30, 2007, the employer must make a further submission that lists the employees and provides detailed information concerning the 2006 option exercises, among other information, and must remit the 409A taxes. Finally, not later than July 15, 2007, the employer must certify certain information to the affected employees.
- Payments by the employer after April 17, 2006 must include late-payment interest.

- In determining the 409A taxes on a 2006 exercise, the employer must compute the 20% tax based on the option spread at time of exercise. For options that vested prior to 2006, the interest-based portion of the 409A taxes must be based on the built-in option spread on *December 31, 2005*, assuming a 35% tax rate and interest from April 17, 2006 through April 17, 2007 (or, if earlier, the date of the employer's further submission summarized above).
- For employers otherwise delinquent in reporting on Form W-2 (Box 12) the 409A inclusion amounts associated with 2006 exercises, participation in the program will also eliminate any penalties and interest related to that reporting delinquency. However, the program requires the employer to pay taxes that would otherwise be owed by the affected employees.

Questions regarding the Announcement should be referred to Loretta Richard, Jon Zorn or Ron Groves.

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