
IRS Announces Program Permitting Employers to Pay 409A Taxes for Employees Who Exercised Discounted Stock Options in 2006-Immediate Action Required

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Overview

On February 8, 2007, the Internal Revenue Service released Announcement 2007-18, which unveils a compliance resolution program (the Program) permitting employers to pay the taxes arising under Section 409A of the Internal Revenue Code (the Code) due to the exercise of certain discounted stock options and stock appreciation rights in 2006. The Program does not afford any reduction in the amount of Section 409A taxes due with respect to the exercise of discounted stock rights. However, the Program may minimize the administrative burdens on employers of complying with their Section 409A reporting obligations and may enhance employee relations.

As explained in more detail below, the Program:

- Applies to exercises of discounted stock rights during 2006 by employees and former employees, except for employees and former employees who are currently subject to the disclosure requirements of Section 16 of the Securities Exchange Act of 1934 (Section 16 persons) and those who were Section 16 persons on the grant date of the discounted stock rights
- Requires full payment by the employer of the 20% penalty and interest taxes imposed by Section 409A as a result of the exercise of the discounted stock rights, and relieves the employees of their 409A taxes with respect to such exercises
- Imposes a strict schedule pursuant to which employers must notify the IRS of their intent to participate in the Program by February 28, 2007

For a summary of the reporting, withholding and tax payment rules under 409A as provided in Notice 2006-100, please see our December 4, 2006, [email alert](#).

Background

The American Jobs Creation Act of 2004 added Section 409A to the Code. Section 409A provides

that all amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in income, unless strict timing and documentary requirements are satisfied. A violation of Section 409A results in the assessment of a 20% penalty and interest taxes on the employee or service provider, in addition to regular income and employment taxes.

Discounted stock rights--stock options and stock appreciation rights that have an exercise price that is less than the fair market value of the company's stock on the grant date--that vest on or after January 1, 2005, are subject to Section 409A. An employee who exercised a discounted stock right in 2006 is required to include in income the spread on the date of exercise--the excess of the fair market value of the underlying stock on the exercise date over the exercise price--and to pay all regular income and employment taxes with respect to such spread. Section 409A imposes on the employee a 20% penalty tax on the spread and, to the extent that the discounted stock right was vested on December 31, 2005, a tax in an amount equal to the interest on the income the employee would have recognized if the discounted stock right had been exercised on December 31, 2005.

Terms of the Program

Announcement 2007-18 sets forth the following terms of the Program:

- Employers can make a single payment to the IRS on behalf of their employees for the Section 409A taxes arising from the exercise of discounted stock rights in 2006. The Program is available for exercises of discounted stock rights by all employees and former employees other than those who were Section 16 persons on the grant date of the discounted stock rights and those who are currently Section 16 persons.
- Employers must notify the IRS by February 28, 2007, of their intent to participate in the Program. Employers must then comply with a strict schedule of notice, certification and payment obligations as set forth in Announcement 2007-18.
- Employers must submit specified information and make payment of the 409A penalty taxes by June 30, 2007. Payments made after April 17, 2007, may be subject to additional interest charges.
- The amount of Section 409A penalty taxes paid by the employer on behalf of each employee is considered compensation to the employee in 2007 and must be reported accordingly. The employer is permitted to gross-up the employee for this additional income.
- All regular income and employment tax reporting, withholding and payment obligations continue to apply to the employer and employee with respect to the exercise of the discounted stock right.

Scope of Relief under the Program

- **Relief for Employers.** Employers participating in the Program will not be required to report the 409A income amount with respect to the discounted stock right in box 12 of Form W-2 using code Z for 2006. If an employer has already reported the 409A income amount on the employees' Forms W-2, the employer may provide Forms W-2c that do not report the 409A amount.
- **Relief for Employees.** Employees of participating employers will not be required to pay the 409A penalty taxes arising on the exercise of discounted stock rights in 2006.

Our Recommendations

Because the Program offers no reduction in the amount of Section 409A penalty taxes payable, employers who intend to satisfy these amounts on behalf of their employees should carefully consider whether participation in the Program will alleviate the administrative burdens associated with their Section 409A reporting obligations and simplify their employee communications before moving forward. Moreover, employers who intend to satisfy the Section 409A penalty taxes arising on the exercise of discounted stock rights by Section 16 persons must do so outside the Program.

For more information on this or other tax matters, please see our [tax publications](#), or contact:

A. William Caporizzo

+1 617 526 6411

william.caporizzo@wilmerhale.com

R. Scott Kilgore

+1 703 251 9744

scott.kilgore@wilmerhale.com

Amy A. Null

+1 617 526 6541

amy.null@wilmerhale.com

William H. Schmidt

+1 617 526 6946

bill.schmidt@wilmerhale.com

Linda K. Sherman

+1 617 562 6712

linda.sherman@wilmerhale.com

Kimberly B. Wethly

+1 617 526 6481

kimberly.wethly@wilmerhale.com

Authors



**Kimberly B.
Wethly**

PARTNER

Chair, Tax Practice

✉ kim.wethly@wilmerhale.com

☎ +1 617 526 6481