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IRS Issues Guidance to Section 16 Persons Who Do Not Cure Discounted Stock Options by December 31, 2006

2006-12-04

Overview

On November 30, 2006, the Internal Revenue Service issued Notice 2006-100, which provides interim guidance to employers and other payers regarding their reporting and withholding obligations for calendar years 2005 and 2006 with respect to deferrals of compensation and amounts includible in gross income under Section 409A of the Internal Revenue Code (the Code). The notice also provides guidance to employees and other service providers on their income tax reporting and tax payment obligations with respect to amounts includible in income under Section 409A for 2005 and 2006.

This email alert summarizes the effect of the interim reporting and withholding guidance on persons subject to the disclosure requirements under Section 16 of the Securities Exchange Act of 1934 who hold discounted stock options that vested on or after January 1, 2005, and that are subject to Section 409A. As explained in more detail below, unless those stock options are corrected before December 31, 2006, the following rules apply for calendar years 2005 and 2006:

- Section 16 persons are required to include the option spread on vested options as of December 31 in income for each such year, to the extent not previously included in income.
- The amount included in income is subject to the 20% Section 409A penalty tax and interest, in addition to regular income and employment taxes.
- Employers and payers are required to report the option spread on vested options for each such year to the extent not previously reported; however, employers are only required to withhold income and employment taxes with respect to such amounts for 2006. No withholding of the Section 409A penalty tax or interest is required.

Background

Stock options that were granted or that vest on or after January 1, 2005, and that have an exercise price that is less than the fair market value of the company's stock on the date of grant are subject to Section 409A (referred to as Discounted Options). If the Discounted Options are not corrected by either fixing the payment terms or increasing the exercise price to fair market value as of the date of grant, such options will violate Section 409A and be subject to a penalty tax and interest in addition to regular income and employment taxes. While the IRS has generally extended the deadline for implementing such corrections to December 31, 2007, the additional transition relief does not apply to—and a December 31, 2006 correction deadline is in effect for—any Discounted Option that:

- was granted by a company—the stock of which was publicly traded at the time the Discounted Option was granted;
- was granted to a person who, as of the date of grant, was subject to the Section 16 disclosure requirements with respect to such company; and
- with respect to the grant of the Discounted Option, the company either has reported or reasonably expects to report a financial expense due to the issuance of the Discounted Option that was not timely reported in the financial statements or reports for the period in which the related expense should have been reported under generally accepted accounting principles.

Amount Includible in Income for Discounted Options that are Not Corrected by December 31, 2006

Notice 2006-100 sets forth the following rules for determining the amount includible in income by Section 16 persons who do not take curative action with respect to Discounted Options by December 31, 2006:

- ***For Discounted Options that vested in 2005 and that continued to be held on December 31, 2005***, the Section 16 person is required to include in income for 2005 an amount equal to the excess of the fair market value of the underlying stock on December 31, 2005, over (i) the exercise price; and (ii) any amount paid for the option. This option spread is subject to regular income and employment taxes, plus a 20% penalty tax and interest under 409A. Employers have a reporting obligation, but no withholding obligation, with respect to the 2005 income amount.
- ***For Discounted Options that vested in 2005 or 2006 and that continue to be held on December 31, 2006***, the Section 16 person is required to include in income for 2006 an amount equal to the excess of the fair market value of the underlying stock on December 31, 2006, over (i) the exercise price; (ii) any amount paid for the option; and (iii) any amount previously included in income with respect to such Discounted Option (for example, any option spread required to be included in income in 2005). This option spread is subject to regular income and employment taxes, plus a 20% penalty tax and interest under 409A. Employers have both a reporting and a withholding obligation with respect to the 2006 income amount. Employers must withhold regular income and employment taxes at supplemental income tax rates with respect to such amount; however, no withholding of the Section 409A penalty tax or interest is required.
- ***For Discounted Options that vested in 2005 and that were exercised in 2005***, no additional reporting, withholding or tax payment obligations (including no Section 409A penalty tax) should arise solely as a result of Section 409A because of special transition rules in effect for 2005.

- ***For Discounted Options that vested in 2005 or 2006 and that were exercised in 2006***, the Section 16 person is required to include in income for 2006 an amount equal to the excess of the fair market value of the underlying stock on the date of exercise over (i) the exercise price; (ii) any amount paid for the option; and (iii) any amount previously included in income with respect to such Discounted Option (for example, any option spread required to be included in income in 2005 for an option that vested but was not exercised in 2005). This amount is subject to regular income and employment taxes, plus a 20% penalty tax and interest under 409A. Employers should have timely reported and withheld at the time of the exercise, and such exercise also should be reported on annual information returns. No additional withholding of the Section 409A penalty tax or interest is required.

Other Guidance

Notice 2006-100 provides detailed guidance regarding the income tax reporting and payment obligations of Section 16 persons who are required to include amounts in income pursuant to Section 409A for calendar years 2005 and 2006. The Notice also includes detailed guidance regarding employers' withholding and reporting obligations with respect to amounts required to be included in the income of their employees as a result of the application of Section 409A during calendar years 2005 and 2006. For full text of our email alert that provides a thorough summary of the reporting, withholding and tax payment rules under Notice 2006-100, please click here.

Our Recommendations

If Section 16 persons, together with their employers or payers, are aware that they have Discounted Options outstanding, corrective action should be taken by December 31, 2006, in order to avoid the Section 409A income inclusion and penalty taxes described above. Acceptable corrective action includes either fixing the payment terms or increasing the exercise price to the fair market value on the date of grant. An employer or payer that is currently undergoing an options timing investigation and will not have established a redetermined grant date by December 31, 2006, should consider amending Discounted Options in writing signed by the affected Section 16 person on or before December 31, 2006—either to fix the payment terms or to provide that the exercise price of such options will be increased to the fair market value of the underlying stock on any redetermined grant date, and that the Discounted Options are not exercisable until such determination is made (usually upon the company's filing of restated financial statements with the Securities and Exchange Commission). Finally, Section 16 persons and employers and payers who have not yet determined whether they have any Discounted Options should begin an immediate and comprehensive review of their outstanding stock options.

For more information on this or other tax matters, please see our prior tax publications, or contact:

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