



IRS Settlement Program Regarding Discounted Stock Rights

On February 8, 2007, the IRS announced a new settlement program that will allow certain employers to address tax issues that may have been triggered by the issuance of discounted stock options and stock appreciation rights ("SARs"). Specifically, the program allows employers, who issued discounted options or SARs that were exercised by employees during 2006 in violation of Code §409A, to pay the Section 409A taxes on behalf of most employees. By doing so, the employer will avoid having to report the Section 409A violation on the affected employees' Form W-2s, and will relieve them from personal liability for the Section 409A taxes. However, the time frame for deciding whether to participate is very restrictive:

Employers who wish to participate in the special program must make an initial filing with the IRS by February 28, 2007.

Background

Section 409A, enacted in 2004 (please reference our previous Alert on section 409A entitled *Congress Rewrites the Rules on Deferred Compensation Plans*) imposes a number of new requirements and limitations on "non-qualified deferred compensation plans". This term includes most discounted stock rights - that is, stock options or SARs that have an exercise price or value less than the underlying stock's fair market value as of the date the right is granted - unless they were fully vested as of December 31, 2004. In most cases, discounted stock rights violate Section 409A because they do not have a fixed exercise date; Section 409A requires that deferred compensation be paid out only at specified times or upon the occurrence of certain specific events. As we noted in our *Deferred Compensation Plans Alert*, violation of Section 409A results in the immediate taxation of all vested deferred compensation, as well as interest on the tax "underpayment" and a 20% penalty tax, all of which are payable by the employee.

In previously issued rulings, the IRS has provided transition relief so as to allow employers to bring discounted stock rights into compliance with Section 409A. For example, discounted stock rights were allowed to be exercised in 2005 without violating Section 409A. Furthermore, employers generally have until December 31, 2007 to amend discounted stock rights to comply with Section 409A. However, if a covered stock right was exercised in 2006, before the option or SAR was amended to comply with the new law, a Section 409A violation has occurred and the associated taxes are triggered: the deferred compensation (the spread or discount) is subject to income tax, and the 20% penalty tax and the interest charge are also payable by the employee.

If these taxes were triggered by the exercise of a discounted stock right in 2006, this may come (or may already have come) as an unpleasant surprise to an employee who didn't realize that exercis-

ing the stock right would cause a 20% penalty tax and an interest charge to be added to his or her 2006 tax bill. And the employer may be faced with a rather serious employee relations problem, especially if it had promised favorable tax treatment for the stock right plan.

The Announcement 2007-18 Program

The new IRS program, which is set forth in Announcement 2007-18 provides as follows:

- The employer must pay the 20% penalty tax and the interest charge on behalf of the employee.
- If the employer does so:
 - It need not report the Section 409A violation on the employee's 2006 Form W-2.
 - The employee is relieved from personal responsibility for the Section 409A taxes paid by the employer (which otherwise would have been due and payable with the employee's 2006 tax returns).
- The penalty tax and interest paid by the employer on the employee's behalf will be taxable compensation to the employee in 2007. Accordingly, an employee will not be fully "made whole" unless the employee's 2007 compensation is grossed up to account for the additional tax on this imputed income.

In order to take advantage of this program, the employer must notify the IRS by February 28, 2007. Thereafter, the employer must take the following additional actions:

<u>Deadline</u>	<u>Action(s) Required</u>
March 15, 2007 (or 15 days after the IRS filing)	<ul style="list-style-type: none">- The employer must notify all affected employees- The employer must file a second notice with the IRS, stating the number of affected employees who were notified
June 30, 2007	The employer must file detailed information with the IRS with respect to the employees and stock rights covered by the filing, and remit full payment of the Section 409A taxes owed.
July 15, 2007	The employer must again notify all employees who received the earlier notice, certifying that the employer has paid the Section 409A taxes, or advising them if it has not.

The last two dates fall on Saturday and Sunday, respectively. The IRS submission due on June 30, 2007 most likely could be mailed by July 2, 007 (the next business day), in accordance with the usual IRS rule regarding filing dates. Although it's possible that the deadline for the employee notice (July 15, 2007) would also be extended to the next business day, this isn't certain, and employers using this program should assume that the notice is due by July 15, 2007 unless and until the IRS provides further guidance.

Announcement 2007-18 states detailed requirements for each of these filings and notices.

Scope of the Program

The IRS settlement program is only of use to employers who issued discount stock options or SARs that were exercised by one or more employees during 2006 in violation of Section 409A. The program doesn't apply with respect to stock rights exercised by employees who are subject to Section 16(a) of the Securities Exchange Act.

What Affected Employers Should Do

If an employer is eligible for the program, the settlement program offers a viable way to assist employees who would otherwise be subject to Section 409A taxes as a result of a 2006 transaction - possibly, without realizing that this would happen. It would also allow employers to remedy multiple Section 409A violations on a group basis, without having to address each transaction individually. If an employer elects to take advantage of the program, it must pay the full 20% penalty tax and the interest charge immediately on behalf of affected employees. These payments will be treated as taxable compensation to affected employees in 2007, resulting in additional taxes.

If you have any questions or would like more information regarding Section 409A and stock rights generally, please contact any member* of our Employee Benefits practice group:

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