

**Checkpoint Contents**

Federal Library

Federal Source Materials

IRS Rulings &amp; Releases

Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases  
& Other IRS Documents

Announcements (1959 to Present)

2007

Ann. 2007-18, 2007-9 IRB, 02/08/2007 ~~advance~~

---

**Announcements****Announcement 2007-18, 2007-9 IRB, 02/08/2007, IRC Sec(s).**

---

**Headnote:****Reference(s):****Full Text:**

The Internal Revenue Service announces a compliance resolution program (the Program) that permits employers to pay the additional taxes arising under § 409A of the Internal Revenue Code due to the exercise of certain discounted stock options and stock appreciation rights (stock rights) in 2006. The Program provides a means to minimize the burdens of compliance on employees who are not corporate insiders, while ensuring that all applicable taxes are paid. As described in more detail below, the Program:

- Applies only to discounted stock rights exercised during 2006.
- Applies only to employees and former employees who are not subject to the disclosure requirements under section 16(a) of the Securities Exchange Act of 1934 (a non-insider), and were not subject to such requirements at the date of grant of the stock right.
- Requires full payment by the employer of the applicable § 409A taxes arising from the exercise of the stock right.
- Provides relief for the employees from the requirement to pay the § 409A taxes.
- Does not affect an employer's obligation to report the compensation income and wages arising from the exercise of the stock right on the Form W-2, in Box 1, 3 and 5, and to apply the appropriate employment taxes, and does not affect an employee's obligation to report such compensation income on the Form 1040 and pay the applicable income tax (other than the additional § 409A taxes).
- Requires treatment of the employer's payment of the employee's § 409A taxes as an additional payment of compensation to the employee in the employee's taxable year in which the payment is made.
- Requires notice to employees and to the IRS of the employer's participation in the Program.

Employers that wish to participate in this Program must notify the IRS no later than February 28, 2007 of their intent to participate, and must notify affected employees within 15 days of providing the notification to the IRS.

**1. Background****A. Section 409A**

Section 409A was added to the Code by § 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1418). Section 409A generally provides that, unless certain requirements are met, 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 gross income. In addition, the amount includible in income under § 409A is subject to certain additional taxes discussed below (referred to as § 409A taxes).

On December 20, 2004, the IRS issued Notice 2005-1 (2005-2 CB 274), setting forth initial guidance on the application of § 409A, and supplying transition guidance in accordance with the statutory provisions. A notice of proposed rulemaking (REG-158080-04, 2005-43 IRB 786 [70 FR 57930]) was published in the Federal Register on October 4, 2005. The preamble to the proposed regulations clarified and extended certain provisions of the transition guidance provided in Notice 2005-1, generally through December 31, 2006. On October 4, 2006, the IRS issued Notice 2006-79 (2006-43 IRB 763), which further clarified and extended certain provisions of the transition guidance through December 31, 2007.

Pursuant to Notice 2006-100 (2006-51 IRB 1109), issued on November 30, 2006, service recipients generally are required to report amounts includible under § 409A for 2006 on a timely filed Form W-2 or 1099, as applicable. Service providers are required to report amounts includible under § 409A for the service provider's 2006 tax year and to pay any taxes due in accordance with the requirements of Notice 2006-100.

#### B. Application of § 409A to Certain Discounted Stock Rights

The IRS has become aware of numerous instances in which stock options were issued with an exercise price less than the fair market value of the underlying stock on the date of grant or in which stock appreciation rights were issued under which the compensation payable upon exercise of such right was more than the excess of the fair market value of the stock subject to such right on the date of exercise over the fair market value of such stock on the date of grant of such right (collectively such options and rights are referred to as discounted stock rights). In many cases, the discount resulted from a discrepancy between the purported grant date and the actual grant date. In some cases, the employee exercised the stock right during 2006.

Such discounted stock rights, to the extent they were issued or became earned and vested on or after January 1, 2005, are generally treated as providing nonqualified deferred compensation subject to § 409A. By contrast, a stock option granted with an exercise price that can never be less than the fair market value of the underlying stock on the date of grant, and that does not include any additional deferral feature, generally is not subject to § 409A, and the exercise of such stock option does not implicate § 409A. Similarly, a stock appreciation right that does not provide compensation in excess of the difference between the fair market value of the stock subject to such right on the date of exercise and the fair market value of such stock on the date of grant of such right, and that does not include any additional deferral feature, generally is not subject to § 409A, and the exercise of such stock right does not implicate § 409A.

#### C. Consequences Under § 409A of the Exercise of Certain Discounted Stock Rights in 2006

In the absence of affirmative steps taken before the exercise of a stock right to avoid a violation of § 409A, the exercise of a discounted stock right during 2006, where the term of the stock right otherwise extended beyond 2006, generally is treated as an impermissible payment of nonqualified deferred compensation under § 409A. Such an impermissible payment generally triggers adverse Federal income tax consequences under § 409A for the service provider, and reporting requirements for the service recipient, with respect to the stock rights that were exercised and with respect to any additional amounts that are treated as deferred under the same plan for purposes of § 409A under the applicable plan aggregation rules. Such tax consequences include immediate income inclusion; an additional 20% income tax (in accordance with § 409A(a)(1)(B)(i)(II)) on the amounts required to be so included (the 20% tax); and a second additional tax (in accordance with § 409A(a)(1)(B)(ii)) equal to the interest on unpaid taxes from the year of initial deferral (or if later, the first year the deferred amount was not subject to a substantial risk of forfeiture), calculated at the underpayment rate plus 1% (the

interest tax).

Notice 2006-100 provides that where there is a required income inclusion under § 409A in the service provider's tax year 2006, the plan aggregation rules apply in determining the amount required to be included in income. For purposes of participation in, and the relief provided by, the Program, taxpayers may assume, in the case of a violation involving a stock right, that the plan aggregation rules apply only to aggregate all amounts deferred under stock rights subject to § 409A held by the employee with respect to whom the violation occurred. In the case of an unexercised stock right, Notice 2006-79 permits the service recipient to substitute for such a stock right a stock right that is not subject to § 409A. In the case of certain stock rights granted to a service provider who was subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934 on the date of grant of the stock right, the substitution was required to be completed by December 31, 2006. For other service providers, the substitution must be completed by December 31, 2007. If a taxpayer utilizes the available transition rules to exclude a right to an amount (including an unexercised stock right) from coverage under § 409A, then the amount is treated as always having been excluded from coverage under § 409A. Accordingly, the amount is not required to be aggregated for purposes of determining the amount includible in income under § 409A in 2006. If the right to the amount is not excluded from coverage under § 409A by the applicable deadline, the right to the amount will remain subject to the plan aggregation rules regardless of whether the right to the amount is, or is amended to be, compliant with the requirements of § 409A. However, because a stock right may be removed from coverage under § 409A retroactively, any income inclusion under § 409A with respect to an unexercised stock right due to the plan aggregation rules will not be treated as income for any of the service provider's taxable years before the 2007 tax year.

## **2. Scope of Program**

This Program addresses only the additional § 409A taxes for the employee's 2006 tax year resulting from the exercise of an applicable stock right (discussed below), and the information reporting requirements related to such § 409A taxes. The Program does not address other consequences that may arise from the grant or exercise of a stock right with an exercise price less than the fair market value of the underlying stock on the date of grant. Accordingly, the Program does not address the employer's obligation to report the compensation income arising from the exercise of the stock right on the 2006 Form W-2, in Box 1, 3 and 5, as appropriate, and to apply the appropriate employment taxes to the payment of wages. The Program also does not address the employee's obligation to report such compensation income on the Form 1040 and pay the applicable income tax (other than any additional § 409A taxes). The Program also does not address the non- § 409A tax consequences, including employment tax and information reporting consequences, that may arise from a failure of a purported incentive stock option to meet the requirements of § 422, or the application of § 162(m) to an employer's otherwise available deduction for compensation expense with respect to the exercise of a stock right.

## **3. Eligibility Requirements**

This Program is available to an employer that granted applicable stock rights that were subject to the requirements of § 409A because the exercise price was below the fair market value of the underlying stock on the date of grant, where such stock rights were exercised during the employee's 2006 tax year. For this purpose, an applicable stock right means any stock right granted in connection with the performance of services by an employee other than a stock right granted to an employee who is subject to the disclosure requirements of section 16(a) of the Securities Exchange Act of 1934 as of the date the employer provides a notice of intent to participate in the program under section 4.A or who was subject to such disclosure requirements on the date of grant of such stock right.

## **4. Terms of Participation in the Program**

If an employer complies with all of the requirements in this section 4 with respect to an employee, the employer and the employee will be eligible for the relief set forth in section 5 of this announcement:

#### A. Notice to the IRS of Intent to Participate

An employer must submit to the IRS by February 28, 2007 a notice of the employer's intent to participate in the Program. The notice of intent to participate must state, under penalties of perjury, the following: [Insert name of the employer and taxpayer identification number] hereby provides notice to the IRS of its intent to participate in the Program described in Announcement 2007-18. [Insert name] is the person for the IRS to contact regarding the participation of [Insert name of the employer] in the Program, and may be contacted at [Insert address and phone number]. *Choose either sentence A or sentence B. Sentence A.* [Insert name of the employer] hereby certifies that [Insert name of the employer] is not under examination by the IRS. *Sentence B.* [Insert name of the employer] hereby certifies that [Insert name of the employer] is under examination by the IRS and is providing a copy of this notice of intent to participate in the Program to the examining revenue agent.

An employer must also submit a Form 2848, Power of Attorney and Declaration of Representation, as appropriate. For information regarding the submission of this notice, see section 6 of this announcement.

#### B. Notices to Affected Employees and IRS

##### i. Notice to Affected Employees of Intent to Participate

No later than 15 days after the employer submits the notice of intent to participate described in section 4.A of this announcement, an employer must provide a notice to all employees that the employer reasonably anticipates may be affected by the employer's participation in the Program. Such notice must provide the following information:

- (i) the employer has notified the IRS of the employer's intent to participate in the Program (the Program must be specifically referred to in the notice to employees as the program set forth in Announcement 2007-18, Compliance Resolution Program for Employees Other than Corporate Insiders for Additional 2006 Taxes Arising Under § 409A due to the Exercise of Stock Rights);
- (ii) the employer intends to provide further notice to the employee on or before July 15, 2007 certifying that the employer has made a further submission to the IRS that to the best of its information, knowledge, and belief, satisfies the requirements of this announcement, or certifying that the employer has not made such a further submission;
- (iii) the employer's participation in the Program may affect the employee's Federal income tax obligations solely with respect to the additional taxes imposed under § 409A of the Internal Revenue Code due to the exercise of discounted stock options or stock appreciation rights, but does not affect the employee's obligation to report on Form 1040 the compensation income arising from the exercise that is shown on the Form W-2 (or W-2c, if applicable) provided to the employee or to pay the applicable Federal taxes (other than the additional § 409A taxes).

The notice to affected employees may provide additional information that is not inconsistent with the required information. The notice must be provided directly to the individual employee, but may be provided electronically. If an employer provides such notices to employees that the employer reasonably anticipates may be affected by the employer's participation in the Program, and subsequently determines that an exercise of a stock right by an additional employee is eligible to be included in this Program, the employer may include such additional employee and exercise in a further submission without providing the notices required by this Section 4.B, provided all other requirements of this announcement are met with respect to such additional employee.

##### ii. Second Notice to IRS

No later than 15 days after the employer submits the notice of intent to participate described in section 4.A of this announcement, the employer must provide a notice to the IRS stating the number of employees to whom the notices required by section 4.B.i of this announcement were provided.

### C. Employer's Further Submission of Information and Payment to the IRS

An employer must make a further submission of information and payment (a further submission) to the IRS by June 30, 2007 meeting all of the requirements of this section 4.C.

#### i. Information

An employer must include in the further submission to the IRS the following information, signed under penalties of perjury:

- a. The employer's name and taxpayer identification number.
- b. A list of employees for whom the employer is remitting the § 409A taxes due (the 20% tax and the interest tax) under section 4.C.ii below, including each such employee's taxpayer identification number.
- c. For each identified employee, an identification of each stock right exercise resulting in the § 409A taxes, including information that specifically identifies the specific stock right that was exercised, the date of exercise, the exercise price, the fair market value of the underlying shares on the date of exercise, and the number of shares purchased or, in the case of a stock appreciation right, the number of shares used to calculate the payment made.
- d. For each identified stock right exercise for each identified employee, the amount of § 409A taxes remitted, including the manner in which such § 409A taxes were calculated.

#### a. Remittance of Taxes

With respect to an exercise of a stock right subject to § 409A by an employee during 2006, the employer must remit to the IRS by June 30, 2007, an amount equal to the full amount of the additional tax liability of the employee under § 409A that results from such exercise. Such additional tax consists of the 20% tax and the interest tax described below. For purposes of determining the § 409A taxes, the amount of income includible under § 409A must be determined in accordance with applicable guidance under § 409A. With respect to such exercise of a stock right, an employer is treated as having remitted an amount equal to the full amount of the additional tax liability if the employer remits substantially all of the additional tax liability based upon a reasonable, good faith interpretation of the applicable guidance. Where it is determined that an employer has failed to submit substantially all of the additional tax liability that results from the exercise of a stock right subject to § 409A during 2006 based upon a reasonable, good faith interpretation of the applicable guidance, neither the employer nor the employee is entitled to any relief under this announcement with respect to the § 409A taxes resulting from the exercise of such stock right.

#### b. Calculation of the 20% tax

For purposes of this Program, the amount of the 20% tax equals 20% of the excess of the fair market value of the stock on the date of exercise over the sum of the exercise price paid by the employee and any other amount paid by the employee for the stock right. See Notice 2006-100.

#### c. Calculation of the Interest Tax

For purposes of this Program, the amount of the interest tax equals the amount of interest at the

underpayment rate plus 1% on the underpayment of Federal income tax that would have occurred had the portion of the amount deferred under the stock right as of December 31, 2005, that was not subject to a substantial risk of forfeiture (as defined for purposes of § 409A) as of December 31, 2005, been includible in gross income as of December 31, 2005. For this purpose, the amount deferred under the stock right as of December 31, 2005 equals the excess of the fair market value of the underlying stock on December 31, 2005 over the sum of the exercise price and any other amount paid by the employee for the stock right. For purposes of this Program, employers must calculate the underpayment based on the highest marginal Federal income tax rate in effect for 2005 (35%). For purposes of determining the applicable interest, the underpayment is treated as due on April 17, 2006, and the interest runs from that date through the earlier of April 17, 2007 or the date the further submission is sent to the IRS with payment.

d. Additional Amount Due for Taxes Remitted After April 17, 2007

For payments sent to the IRS after April 17, 2007, the amount required to be submitted is increased by an amount equal to the underpayment interest rate applied to the amount that would otherwise be due on April 17, 2007 through the date the further submission (with payment) is sent to the IRS.

iii. Section 409A Tax Payments Constitute Compensation to the Employee

The payment of the § 409A taxes due as part of this Program constitutes additional compensation income to the employee for the employee's taxable year in which such payment is made. Accordingly, the employer must represent under penalties of perjury that the employer is treating such payment as additional compensation to the employee for the taxable year of such employee in which such payment is made, in accordance with this section iii. With respect to any employee for whom a payment of § 409A taxes has been made as part of the further submission, no relief shall be provided under this announcement with respect to the exercise of a stock right by such employee during 2006 if it is determined that the employer has failed to treat such payments as additional compensation for the taxable year of such employee in which such payment is made, in accordance with this section iii.

Payments made on behalf of an employee or former employee to cover § 409A taxes are wages for Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Federal income tax withholding purposes for the employee's taxable year in which the payment is made. Such wages, as well as any additional wages resulting from the employer's payment of the employee's share of FICA tax and income tax without withholding such amounts from the employee, must be reported on Form 941, Employer's Quarterly Federal Tax Return, and in box 1, 3 and 5 of the employee's Form W-2, Wage and Tax Statement, for the year in which the payment is made. See Rev. Rul. 58-113 (1958-1 CB 362) and Rev. Proc. 81-48 (1981-2 CB 623), for methods of computing gross wages when paying FICA and Federal income tax withholding on behalf of an employee.

iv. Further Representations by the Employer

The further submission must include the following representations by the employer, signed under penalties of perjury:

a. In accordance with section 4.B.i of this announcement, the employer provided the notices of the employer's intent to participate in the Program to all employees the employer reasonably anticipated would be affected by the employer's participation in the program by no later than 15 days after the employer submitted its notice of intent to participate in the Program to the IRS.

b. With respect to any employee for which a payment of § 409A taxes has been made as part of the further submission, the employer has made reasonable, good faith efforts to identify all exercises of a stock right by such employee during 2006 that resulted in the inclusion of income under § 409A, applying a reasonable, good faith interpretation of the applicable guidance under § 409A, has listed all such identified exercises of a stock

right in its further submission, and has accurately calculated and paid the § 409A taxes resulting from such identified exercises of a stock right in accordance with this announcement.

c. The employer will, upon a written request from an affected employee, disclose to the employee any portion of such information that is relevant to the employee's 2006 Federal income tax return, including information the employee reasonably needs to respond to an information request from the IRS, an examination, or tax litigation involving issues related to the exercise of a stock right and the application of § 409A.

#### D. Notice to Affected Employees of the Employer's Further Submission

An employer must provide a notice to all employees to whom a notice was provided pursuant to section 4.B.i, and any additional employees that are listed in the employer's further submission to the IRS, by no later than July 15, 2007, certifying the following:

- (i) the employer has made a further submission under the Program, that is specifically referenced as the program provided under Announcement 2007-18, Compliance Resolution Program for Employees Other than Corporate Insiders for Additional 2006 Taxes Arising Under § 409A due to the Exercise of Stock Rights, that to the best of the employer's information, knowledge and belief, satisfies the requirements of this announcement, and that such further submission (a) includes the employee and makes payment of such employee's § 409A taxes addressed by this announcement or (b) does not include the employee because the employer has concluded that the employee does not owe any § 409A taxes addressed by this announcement, or
- (ii) the employer has failed to make a further submission under the Program, that is specifically referenced as the program provided under Announcement 2007-18, Compliance Resolution Program for Employees Other than Corporate Insiders for Additional 2006 Taxes Arising Under § 409A due to the Exercise of Stock Rights, and the employee is therefore liable for any applicable § 409A taxes.

The notice to affected employees may provide additional information that is not inconsistent with the required information. The notice must be provided directly to the individual employee, but may be provided electronically.

## 5. Scope of Relief

### A. Employer's Information Reporting Requirements

If an employer complies fully with the provisions of section 4 with respect to an exercise of a stock right by an employee, the employer will not be required to report the § 409A inclusion amount with respect to such stock right exercise in box 12 of Form W-2 using code Z. If an employer complies fully with the provisions of section 4 with respect to an exercise of a stock right by an employee, but has already reported the § 409A inclusion amount with respect to such exercise of a stock right by an employee in box 12 of Form W-2 using Code Z, the employer may provide a Form W-2c that does not report the § 409A inclusion amount in box 12 of Form W-2c using Code Z, and such employer will not be subject to any penalties under § 6721 or § 6722 of the Code. Nothing in this Program relieves the employer of any information reporting requirements with respect to an employee or an exercise of a stock right that was not identified in the employer's further submission. Nothing in this announcement or Program affects the employer's obligation to report the amount that would be required, without regard to § 409A, to be included in income and wages due to the exercise of a stock right, and to withhold and pay the applicable employment taxes, or the employee's obligations to include such amounts in income and pay Federal taxes on them (other than § 409A taxes).

### B. Employee's § 409A Taxes

If an employer complies fully with the provisions of section 4 of this announcement with respect to amounts

includible in income under § 409A due to the exercise of an applicable stock right by an employee during 2006, the employee will not be required to pay the § 409A taxes on the applicable Federal income tax return for the 2006 tax year with respect to such amounts includible in income under § 409A. Nothing in this Program relieves the employee of any § 409A taxes with respect to an exercise of a stock right that was not identified in the employer's further submission, or relieves the employee or employer of any other tax, including Federal income tax and employment taxes that would otherwise arise from the exercise of the stock right. In addition, nothing in this Program addresses or relieves the employee of any § 409A taxes due to participation in a nonqualified deferred compensation plan, other than the exercise of an applicable stock right in 2006.

An employee who received a notice of application under section 4.B.i of this announcement, and who files a return before finding out that, due to a failure by the employer to comply with the requirements for relief set forth in this announcement, the employee is not relieved of the duty to report and pay § 409A taxes, will be treated as having had reasonable cause and as having acted in good faith with respect to the portion of any underpayment that is due to the employee's failure to timely pay § 409A taxes arising from the exercise of an applicable stock right in 2006, and will not be subject to penalties for the 2006 tax year under § 6654 for any estimated tax underpayment attributable to such failure. An employee who received a notice of application under section 4.B.i of this announcement, requested an extension of time to file a return, and files a timely income tax return on extension after learning that he or she is not relieved of the duty to report and pay § 409A taxes due to a failure by the employer to comply with the requirements for relief set forth in this announcement, will not be subject to penalties under § 6651(a)(2) or § 6654 for the failure to timely pay § 409A taxes arising from the exercise of an applicable stock right in 2006, provided such § 409A taxes are paid with the filed return.

#### C. An Employer's Failure to Comply with Representations or Other Actions Required under the Program

Information and representations required under this Program are material, and an employer who knowingly makes a false statement or representation will be deemed to have failed to make a further submission under the Program so that no relief under this Program is available to the employer or any employee. Except as provided in paragraph 5.B with respect to certain penalties, no relief is provided under this Program with respect to an employer or to an employee if the employer fails to comply with the requirements of this announcement, provided that the Commissioner may, in his sole discretion, determine that the employer has substantially complied with the requirements of this announcement with respect to some or all of the employees identified by the employer and that, accordingly, such employer and some or all of such employees are entitled to the relief provided under this announcement.

#### D. An Employer's or Employee's State and Local Information Reporting, Filing and Tax Requirements

Nothing in this Program relieves the employer or employee of any requirements regarding information reporting, filing of tax returns, or the payment of any taxes, to the extent such requirements relate to any state or local tax. This includes any state or local tax information reporting requirement which relates to the Form W-2.

## **6. Procedures for Submission of Notices and Further Submissions to the IRS**

### A. Submissions to the IRS

A notice of intent to participate in the Program in accordance with section 4.A of this announcement, a second notice to the IRS in accordance with section 4.B.ii of this announcement, or a further submission in accordance with section 4.C of this announcement, shall be submitted to the following address:

Internal Revenue Service

Attn: Announcement 2007-18

2001 Butterfield Road

LMSB Team 1160

Downers Grove, IL 60515

#### B. Requests for Further Information and Withdrawals of Applications and Further Submissions

The IRS reserves the right to request further information from an employer at any time following the employer's submission of a notice of intent to participate in the Program. In addition, nothing in this announcement or Program limits or otherwise affects the IRS's right to request further information, to examine a taxpayer's federal tax return, and except as otherwise explicitly provided in this announcement and Program, to assess any unpaid taxes, penalties or interest.

The employer retains the right to withdraw a notice of intent to participate or a further submission at any time on or before June 30, 2007, provided that notices are provided under section 4.D of this announcement that reflect the withdrawal. The employer also retains the right to modify a further submission at any time on or before June 30, 2007, provided that a modification after April 17, 2007 involving the payment of additional § 409A taxes is subject to the requirement of an additional amount due for further submissions after April 17, 2007 with respect to the additional § 409A taxes identified in the modification, and provided that notices are provided under section 4.D of this announcement that reflect the modification. Where an employer withdraws a submission on or before June 30, 2007, the employer is entitled to a return of the funds submitted to the IRS, without interest. Where an employer modifies a further submission in a manner that reduces the § 409A taxes covered by the further submission, the employer may obtain a return of amounts previously submitted to the IRS consistent with such modification, without interest, provided such modification is submitted on or before June 30, 2007. After June 30, 2007, an employer may obtain a return of any amount paid to the IRS with respect to an employee pursuant to the announcement if the employer demonstrates that the employee for whom the § 409A taxes were paid has paid the § 409A taxes in full.

For information about this announcement, call (630) 493-5167 (not a toll free number).

END OF DOCUMENT -

© Copyright 2007 RIA. All rights reserved.