

Executive Compensation and Benefits Memo

Limited IRS Relief for Options and SARs Subject to Deferred Compensation Rules

February 16, 2007

The IRS has announced a program that provides limited relief for certain employees who are subject to additional taxes under the nonqualified deferred compensation rules of tax code section 409A. The relief, which applies to discounted stock rights exercised in 2006, is described in [Announcement 2007-18](#) (the “Announcement”) issued on February 8, 2007.

Background

Section 409A imposes requirements on nonqualified deferred compensation arrangements and significant adverse tax consequences for failure to satisfy those requirements. Such adverse tax consequences include immediate income inclusion, an additional 20% income tax on the amount required to be included in income, and a second additional tax equal to the interest on unpaid taxes from the year of initial deferral (or, if later, the first year the deferral was not subject to a substantial risk of forfeiture) calculated at the underpayment rate plus 1%. (Such additional 20% income tax and additional interest payment, together, are referred to as the “additional 409A taxes.”)

Stock options and stock appreciation rights (together, “stock rights”) generally are exempt from the requirements of section 409A. If, however, a stock right has an exercise price that is less than the value of the underlying stock at the date of grant (a “discounted stock right”), the stock right would be treated as providing for a deferral of compensation that is subject to section 409A unless the stock right was earned and vested on December 31, 2004. In most cases, a discounted stock right that is subject to section 409A would not be 409A compliant and, therefore, would give rise to the additional 409A taxes.

Proposed regulations and other IRS guidance provide that a discounted stock right will not be treated as deferred compensation covered by section 409A if it is canceled and replaced

with a stock right having an exercise price that is at least equal to the value of the underlying stock at the time of original grant. Under that guidance, the cancellation and replacement must be completed by December 31, 2007. For discounted stock rights held by corporate insiders, however, application of the additional 409A taxes may be avoided only if the cancellation and replacement were completed by December 31, 2006. Generally, to avoid the application of section 409A to a discounted stock right, the cancellation and replacement must occur before the right is exercised (although existing guidance does not directly address what steps are required to effect such cancellation and replacement).

IRS Program

The Announcement allows employers to participate in a program intended to minimize the burdens on employees who exercised discounted stock rights in 2006. If an employer elects to participate in the program, the full amount of the additional 409A taxes incurred by the employee would be paid by the employer, subject to the following:

- The employer’s payment will be included in the employee’s income as an additional payment of compensation to the employee in the year in which the payment is made. The program does not change the employer’s obligation to report the compensation income and wages arising from the exercise of the stock right, or relieve the employee from the obligation to report such compensation income on Form 1040 and pay the applicable income tax (other than the additional 409A taxes).
- An employer electing to participate in the program must file an initial notice of its intent to do so with the IRS no later than February 28, 2007, and must notify affected employees within 15 days after providing the notice to the IRS. The employer must provide a second notice to

the IRS, no later than 15 days after the initial notice, stating the number of employees to whom notices were provided. The employer must submit further information to the IRS and pay the additional 409A taxes by June 30, 2007. Other technical requirements also apply.

- The program is not available for discounted stock rights exercised by corporate insiders.

Employers wishing to make their employees whole for additional 409A taxes resulting from the exercise of discounted stock rights may accomplish this without reliance on the program, by providing bonuses to the affected employees in the amount of those taxes. If, instead, an employer chooses to participate in the program, it will pay the additional 409A taxes to the IRS rather than to the employee. However, the

total amount of tax owed by the employee, when added to the tax owed by the employer, is unchanged by the program. Because the program does not reduce the overall amount of taxes due, imposes additional administrative burdens on the employer, and results in little or no reduction in the administrative burdens of employees, it seems likely that it will be attractive to only a limited number of employers.

If you have any questions regarding this topic, we would be pleased to discuss them with you. For more information, please contact any of the attorneys listed below. If you did not receive this *Executive Compensation and Benefits Memo* directly but would like to do so in the future, please send your e-mail address to mnoonan@mayerbrownrowe.com.

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