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Employers should carefully consider the employment tax ramifications of participating in the IRS's new Initiative allowing employers to pay the taxes and interest due on the exercise of backdated or mispriced stock options.

Employment Taxes | A Littler Mendelson Newsletter specifically for the Employment Taxes

Employment Tax Ramifications of Participating in the IRS's Backdated Stock Options Initiative

By GJ Stillson MacDonnell and William Hays Weissman

On February 8, 2007, the Internal Revenue Service (IRS) announced a new initiative (the "Initiative" or "Compliance Resolution Program")[1] which permits employers to pay the 20% additional tax[2] and interest[3] on behalf of their employees in connection with the grant of certain backdated or discounted stock options (or other stock rights) which were exercised in 2006. The IRS has stated that this Initiative provides tax relief for "rank-and-file" employees innocently caught up in the receipt of backdated and misdated stock options issued by their employers. The Initiative is not available for certain high-ranking executives or persons who participated in the backdating.

Internal Revenue Code (Code) section 409A, which rose from the ashes of the Enron, WorldCom and other corporation meltdowns, may impose immediate income tax and penalty tax on employees holding stock options (or other stock rights) where the strike price is lower than the fair market value of the stock at the date of grant. The penalty tax is equal to 20% of the "spread" between strike price and fair market value on the date of grant, with an additional interest assessment. These taxes may arise where options have been backdated, priced incorrectly or otherwise discounted.[4] In contrast, if the option or stock right had been properly priced, and if other criteria were met, an employee normally would not incur tax until the date of exercise.

The Initiative allows employers to step forward and pay the additional 20% tax and any interest that employees owe on options exercised in 2006 only. The additional tax provisions of Code section 409A do not apply to options that were exercisable prior to 2005. An Employer must notify the IRS of their intent to participate in the Initiative by February 28, 2007, and must also contact affected employees by March 15, 2007, to inform them that it has applied to participate in the Compliance Resolution Program. Employers that elect to participate in the Initiative and relieve their affected employees will be required to provide the specific details about the options (or other stock rights), including specifics on the tax calculation that will enable the IRS to ensure the full amount of taxes is paid.

Given this rather short window of opportunity for employers to participate, there a variety of considerations. Chief among those should be employment taxes, including income tax withholdings.

[1] IRS Announcement 2007-18; see also *IRS Offers Opportunity for Employers to Satisfy Tax Obligations of Rank-and-File Employees with 'Backdated' Stock Options*, IR-2007-30, Feb. 8, 2007.

[2] IRC § 409A(1)(B)(i)(II). This additional tax is often referred to as a penalty, however, it is technically a tax and not a penalty. It is, however, punitive, and more appropriately should be referred to as a punitive tax rather than a penalty.

[3] IRC §§ 409A(1)(B)(i)(II), (ii). This provision essentially enhances the amount of interest at issue by one percentage point over the rate in effect for underpayments.

[4] For a more general discussion of 409A, *see The IRS Extends Transitional Rules for Deferred Compensation – And Reminds Employers of Their Current Obligations*, October 2006 ASAP.

The employer's payment of the 409A tax and interest tax constitutes additional compensation to the employee.[5] Thus, payments made pursuant to the Initiative, whether for a current or former employer, must be treated as wages subject to federal income tax withholding, FICA and FUTA taxes and must be reported on both the employer's 941 and the employee's W-2 for 2007. Failure to treat such payment as wages for tax purposes will result in the loss of protection afforded by the Initiative. Employers of course have the option to "gross up" the payment being made, with such gross up also treated as compensation in accordance with the usual rules for grossing up wages.

In considering the employment tax implications, employers should consider the impact that the additional compensation will have on the employees. For example,

- Grossing up could significantly increase the cost for the employer; however, failing to gross up effectively results in the employee still being subject to paying a portion of the cost resulting from the backdated or mispriced stock options. This dilutes some of the impact of offering to assist employees with a tax problem that they may not have even been aware existed.
- Such payments would constitute "supplemental wages" rather than regular wages. For an employee who will reach $1 million or more in supplemental wages, this will result in flat rate withholding at 35% for wages in excess of $1 million.

There are related considerations for employers themselves. For example,

- Employers need to consider whether the payment of the employee's additional tax liabilities under Code section 409A constitutes "reasonable compensation" for purposes of obtaining a business expense deduction under Code section 162. The IRS has not addressed this consideration to date in its Initiative, and it is likely that it will be treated on a case-by-case basis as would any reasonable compensation issue.
- The Initiative simply allows an employer to pay 100% of what is required to be paid for another. In some sense the Initiative is unnecessary, because an employer has always been free to pay expenses for employees. As with many other cases in which an employer pays an employee's expenses, the payment constitutes "compensation" that is subject to tax. Thus, the Initiative offers nothing in exchange for the payment from a tax perspective.

Ultimately, whether to participate is a business decision that should be based on a variety of factors, including employment taxes.

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[5] Announcement 2007-18, p. 8.