

Do You Have Questions about Section 409A?

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You've probably heard about Section 409A, the new federal deferred compensation law that went into effect January 1, 2005. You also probably know something about how it applies to stock options and severance arrangements. But what additional questions should you ask? Here are some possibilities:

Q. I know that discounted nonqualified options are subject to §409A. If my company never issues options at a discount, do we have to worry about §409A?

A. Yes. In order to be exempt from §409A, a garden variety nonqualified option must not only be issued at fair market value, but must also be issued for "service recipient stock." Service recipient stock includes only common stock of the "service recipient" that has the greatest aggregate value of any class of common stock outstanding and not containing any dividend or liquidation preferences. The "service recipient" is the company for which the services are provided and may include (i) the employer company or a company which is under common ownership with the employer using a 50% ownership requirement; or (ii) in the case of a joint venture, the employer company or a company with 20% common ownership.

Q. Does this mean that I can never grant options for preferred stock?

A. No. Incentive Stock Options ("ISOs") are exempt from §409A, and ISOs may be granted for preferred stock. Keep in mind, however, that ISOs may only be granted to employees. A nonqualified option for preferred stock could be exempt from §409A if structured as discussed below.

Q. We promised the Company's new CEO that she would receive an option at a particular price, but never got around to granting the option. The promised price is now less than fair market value. Is there any way that we can grant this option without subjecting the CEO to potential penalties for violating §409A?

A. Yes, a "discount" option can be structured to be exempt from §409A. One way of doing so is to provide that the option vests only upon the first to occur of certain events (such as a change in control of the company or an initial public offering) and must be exercised either within the same tax year of such event or within 2 and 1/2 months of the next year. An important caveat is that the option must provide that if it is not exercised at this time, it will expire. Structuring the option in this way will bring it under the short term deferral exception to §409A because the payment (exercise of the option) will occur shortly after the option is no longer subject to a substantial risk of forfeiture (under the rules of §409A).

Q. I've heard that modifications to an option will cause it to be subject to §409A. Is that true?

A. Yes, but only with respect to certain modifications. Under §409A a modification that causes a reduction in the exercise price or provides the holder with an additional deferral feature or certain extensions of time is considered a new grant. As a result the fair market value requirement will apply as of the date of the modification, which means that if the value of the stock has gone up, the option will not be exempt from §409A. However, certain modifications including (i) acceleration of vesting, (ii) extension of the exercise period to a date not later than the later of the 15th day of the third month following the date the right would have expired or December 31 of the calendar year in which the right would have expired; or (iii) substitutions or assumption in mergers or other corporate transactions where there is no increase in aggregate spread and certain other conditions are met, will *not* be considered a new grant for purposes of §409A. Keep in mind, however, that any extension of the exercise period will constitute a modification for purposes of the ISO rules.

Q. *One of our board members insists that §409A requires private companies to obtain independent appraisals in order to establish the fair market value of stock used for options. Is this true?*

A. No. The Proposed Regulations provide (as has been true with regard to ISOs) that any reasonable method may be used to value private company stock. Whether a determination of fair market value is reasonable is a facts and circumstances test, which will be applied based upon relevant facts including, as applicable, (1) the value of the company's tangible and intangible assets; (2) the present value of future cash flows; (3) the market value of stock in similar businesses; and (4) other relevant factors including control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the company or its shareholders..

The Proposed Regulations do, however, provide certain "safe harbor" valuation methods, which will be presumed reasonable. These safe harbor methods include: (i) valuations based upon an independent appraisal meeting certain strict requirements that has been performed within the past 12 months; and (ii) for start-up companies (less than 10 years of business with illiquid stock and not reasonably anticipating a public offering or change in control of the company within the next 12 months), valuations made reasonably and in good faith, evidenced by a written report that takes into account the valuation factors described above, and made by someone with significant knowledge and experience or training in performing similar valuations.

Q. *You mentioned penalties for violating §409A. What are they?*

A. For any deferred compensation that does not comply with §409A, the employee or service provider is required to include the amount of such compensation in his or her income in the first year in which the compensation is no longer subject to a substantial risk of forfeiture, and a 20% penalty tax is also imposed on this amount. With regard to an option that violates §409A, this means that any spread (difference between exercise price and fair market value of the stock) at the time that the option first vests will be included in income and subject to the 20% penalty tax, even if the option has not been exercised. In addition, any increase in the spread in subsequent years while the option remains outstanding will be included in income and subject to the 20% penalty tax.

Q. *Are there any penalties imposed upon an employer for violating §409A?*

A. No, but the employer may be subject to penalties for failing to comply with withholding or reporting requirements.

Q. *My company is paying severance to a CEO who was terminated six months ago without cause and is entitled under a severance agreement to severance payments for a total of two years. How does §409A apply to this arrangement?*

A. The payments will be exempt from §409A if the amount paid is not more than the lesser of (i) twice the CEO's annual compensation for the calendar year preceding the termination or twice the annual IRS compensation limit for qualified plans for such year (which for 2005 would be twice \$210,000). If the payments exceed this limit, or are paid over more than two calendar years, such payments will be subject to §409A.

Even if the payments are subject to §409A, no penalties will be incurred if the payments are made pursuant to a set schedule (for example, on a monthly basis over two years) and the schedule is not changed, assuming your company is private. If your company is public, §409A requires that payment to the former CEO also be delayed for six months after separation from service.

Q. *My company (which is a private company) has the right to continue the non-competition covenant in our former CEO's employment agreement for up to five years as long as we pay her severance during the applicable period. Do we need to worry about §409A in this case?*

A. The payments will be subject to §409A, but as discussed above this should not be problematic provided that the payments are made pursuant to a set schedule that is not changed.

Q. *Our start-up company is negotiating a voluntary termination and severance arrangement with a departing company founder. Does §409A apply?*

A. Assuming that the founder did not have a prior contractual right to severance pay and the severance is to be paid no later than 2 and 1/2 months after the year in which the termination occurs, the payment is not subject to §409A. If there was an already existing right to severance, or if the severance is to be paid over a period that extends more than 2 and 1/2 months after the end of the year of termination, it may be subject to §409A unless it meets certain exceptions.

The rules of §409A may apply to numerous types of compensation arrangements, and the above is only a very brief sample of some of the issues that may arise. Please consult your attorney if you have questions as to whether §409A may be applicable to any of your company's compensation arrangements.

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