



Proposed Regulations on Nonqualified Deferred Compensation Under IRC 409A

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Exemption for Stock Options and Stock Appreciation Rights

- Incentive stock options and Section 423 purchase rights are exempt
- Non-statutory stock options to purchase service recipient stock are exempt if
 - the exercise price of the option can never be less than the fair market value of the underlying stock on the grant date, and
 - Impact of subsequent repricing
 - there are no deferral features that would delay the recognition of income beyond the exercise date (other than the receipt of unvested stock)

Exemption for Stock Options and Stock Appreciation Rights

- Stock appreciation rights for service recipient stock are exempt if
 - the base price can never be less than the fair market value of the underlying stock on the grant date, and
 - there are no other deferral features other than deferral of income to exercise
- Stock appreciation rights may be eligible for the exemption even if the underlying stock is not traded on an established securities market or if settlement is to be made in cash rather than in shares of stock

Dividend Equivalent Rights

- If accumulated amounts attributable to such rights are payable only to the extent the option is exercised, the payment will be treated as an offset to the exercise price, resulting in the loss of the exemption from Section 409A
- Dividend equivalent rights must be structured as a separate arrangement. Payment can be tied to vesting:
 - If payment is within two and one-half months after the close of the calendar year in which the dividend is credited, no 409A deferred compensation
 - If the payment date is later, must comply with Section 409A distribution rules

Stock of Service Recipient

- Must be common stock of the service recipient that is readily tradable on an established securities market or, if there is none, common stock that represents the highest-value class of outstanding common stock of the service recipient (disregarding any differences in voting rights)
 - If one member of the relevant controlled group has such publicly traded stock, then that stock constitutes service recipient stock for all members of that group
- Stock cannot be subject to any preferences as to dividends or liquidation rights, non-lapse put or call rights, or mandatory repurchase obligations based on a value other than the fair market value of the stock
- American depository receipts (ADRs) qualify

Stock of Service Recipient

- Normal controlled group standard is 80% of fair market value or voting power
- Common stock of parent corporation can qualify as service recipient stock with respect to individuals who perform services for a subsidiary, provided the parent owns stock representing at least 50% of the fair market value or voting power of that subsidiary's outstanding stock
- In certain limited circumstances, the ownership interest can be as low as 20%
- However, the stock of a corporation that serves primarily as an investment vehicle will not qualify as service recipient stock except as to its direct service providers

Determination of Fair Market Value

- Stock readily tradable on established securities market:
 - Last sale price before or the first sale price after the grant, the closing selling price on the grant date or the immediately preceding trading day, or any other reasonable basis using actual transactions
 - Permissible to utilize an average selling price over a specified period within 30 days before or 30 days after the grant, provided:
 - the commitment to grant the option or stock appreciation right, which must include the number of shares to be subject to the stock rights and probably the identity of the recipient, based on such value must be irrevocable before the start of the averaging period, and
 - such valuation method must be used consistently for all grants under the same program

Determination of Fair Market Value

- Stock not readily tradable on established securities market:
 - A value determined by the reasonable application of a reasonable valuation method
 - Factors to be taken into account for reasonable valuation method:
 - The value of the tangible and intangible assets of the corporation, the present value of future cash flows, the market value of stock or equity interests in similar corporations or entities engaged in substantially the same business and other relevant factors, such as control premiums or minority discounts
 - All available information material to the corporation must be considered

Determination of Fair Market Value

- Presumption of reasonableness
 - The consistent use of the following valuation methods will be presumed to result in a reasonable valuation, unless the Internal Revenue Service can establish that the use of such method was grossly unreasonable:
 - A valuation established by an independent appraisal as of a date not more than 12 months prior to the grant date;
 - A valuation formula based on the tax principles governing the valuation of shares subject to non-lapse restrictions, which must be consistently applied for all purposes, compensatory or non-compensatory; or

Determination of Fair Market Value

- For an illiquid stock not subject to any non-lapse put or call right or obligation (other than a first refusal right) and issued by a start-up corporation that has no trade or business which it has conducted for a period of 10 years or more, a written valuation report that takes into account the valuation factors listed above and is prepared by a person with significant knowledge and experience or training in performing similar valuations
 - Valuation report may be prepared by insider
 - However, this valuation method will not be permissible if a change in control or initial public offering of the stock is reasonably anticipated to occur within the succeeding 12 months

Modifications, Extensions and Renewals

- Certain modifications to an existing award will be treated as a new grant which will be subject to Section 409A if the grant has a below-market exercise or base price at the time of such modification
- Modifications that will result in a new grant include:
 - a direct or indirect reduction to the exercise price
 - the addition of a deferral feature

Modifications, Extensions and Renewals

- Multiple repricings of the same option or stock appreciation right may indicate that the exercise price or base price is a floating or adjustable price, with the result that the option or stock appreciation right would fail to qualify for the Section 409A exemption from the date of the original grant

Modifications, Extensions and Renewals

- An extension of the period during which a stock option or stock appreciation right remains exercisable or a renewal of the award will result in a loss of the Section 409A exemption retroactive to the date of the original grant
 - Watch out for change-in-control severance benefit agreements that provide an extended post-termination exercise period for pre-existing grants
 - However, an extension of the term will *not* be deemed to occur if the exercise period is not extended beyond the later of
 - the end of the calendar year in which the grant would have expired in the absence of such extension; or
 - the 15th day of the third month following the normal expiration date

Modifications, Extensions and Renewals

- The following changes to an existing grant will *not* be treated as modifications:
 - The acceleration of the exercise date;
 - The cash-out of the grant for an amount equal to that otherwise payable upon exercise;
 - The addition of a right to deliver previously acquired shares in payment of the exercise price; and
 - The addition of stock withholding rights to satisfy applicable withholding taxes

Modifications, Extensions and Renewals

- An inadvertent modification to an outstanding stock option or stock appreciation right which would otherwise trigger the application of Section 409A to the grant will not be considered a modification, provided such modification is rescinded prior to the earlier of:
 - the date the grant is exercised; or
 - the last day of the calendar year in which the modification occurs

Modifications, Extensions and Renewals

- Assumption or substitution of options in connection with corporate transactions
 - Generally follow Section 424 regulations relating to maintenance of aggregate option spread and ratio of exercise price per share to fair market value
 - Proposed regulations permit departure from exercise price/fair market value ratio so long as there is no increase
- Exercise price adjustments in connection with spin-off transactions
 - Spot price within 60 days
 - Average price within period beginning not more than 30 days before and ending not more than 60 days after the transaction

Restricted Stock, Restricted Stock Units, Phantom Stock

- The issuance of restricted stock will not be subject to Section 409A, regardless of whether the recipient makes a Section 83(b) election with respect to that stock
 - The vesting of non-vested property can be treated as a payment for purposes of Section 409A
- Restricted stock units will not be subject to Section 409A if the stock will be issued in compliance with the short-term deferral exception

Restricted Stock, Restricted Stock Units, Phantom Stock

- Restricted stock units that provide for issuance of vested shares within the short-term deferral period can be structured to allow the recipient to defer the issuance of those shares beyond the short-term deferral period
 - The initial vesting of the award must not occur for at least 13 months following the award date and the recipient must make the deferral election (time and form of distribution) within 30 days after the award date
 - If the deferral election is not made within such 30-day period, then such election will be subject to the 12-month advance election/5-year push-back requirements applicable to changes in the form of timing of distributions

Restricted Stock, Restricted Stock Units, Phantom Stock

- Phantom stock will be subject to Section 409A. However, if the vesting of the phantom stock is tied to the satisfaction of performance factors that qualify as performance-based compensation under Section 409A, then the initial deferral election may be made at any time prior to the last six months of the performance vesting period

Earn-Outs and Other Delayed Payments

- Compensation payable in a change-in-control transaction will be treated as paid at a specified time or pursuant to a fixed schedule in compliance with Section 409A distribution requirements, provided:
 - the compensation is paid on the same schedule and in accordance with the same terms and conditions as payments are to be made to the stockholders in an acquisition of their stock or to the corporation in an acquisition of its assets; and
 - the payments are made within five years after the change-in-control event

Transitional Relief for Below-Market Options and Stock Appreciation Rights

- Exercises on or before 12/31/05 are treated as permissible cancellation of the deferred compensation element
- Can amend to eliminate original grant date discount on or before 12/31/06
 - Post-2005 exercises are not permitted prior to amendment
- Cash or property (restricted stock) issued in replacement of lost discount
 - Permissible in 2005
 - No cash or vested property can be distributed in 2006
 - Post-2006 arrangements are permissible

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