

## **Final Regulations under Section 409A: Implications for Equity Compensation Arrangements**

**May 1, 2007**

As reported in two previous LawFlashes, the IRS has issued final regulations (Final Regulations) under section 409A of the Internal Revenue Code, as amended (the Code). The Final Regulations have an effective date of January 1, 2008, but may be applied earlier to any deferred compensation arrangement subject to section 409A. The key provisions of the Final Regulations as they relate to equity compensation vehicles, such as stock options, stock appreciation rights, restricted stock, restricted stock units, and phantom stock, are summarized below. All plans, agreements, and arrangements subject to section 409A must be reviewed and appropriately revised on or before December 31, 2007 to achieve compliance with section 409A. Every equity compensation plan or arrangement should be reviewed during 2007 to identify and, if applicable, resolve issues under section 409A.

### **Service Recipient Stock**

In order for any stock right to be exempt from section 409A, the underlying stock must qualify as “service recipient stock.” In general, any class of common stock will qualify, whether or not that stock is publicly traded or subject to a transferability restriction or buyback right at fair market value. However, the regulations limit the types of preferences that a class of common stock can include and still qualify. Common stock with a preference limited to liquidation rights can qualify as service recipient stock, but common stock with other preferences (e.g., a preferential right to dividends) will not. Preferred stock cannot constitute service recipient stock under any circumstances.

Service recipient stock includes both the common stock of the corporation for which the grantee is providing services on the grant date and the common stock of any other corporation in an upward chain of corporations, provided they each have a controlling interest in another. In general, the term “controlling interest” requires a 50% interest. However, in limited circumstances in which the use of the service recipient stock is based on legitimate business criteria, the ownership interest can be as low as 20%. As a result, grants of subsidiary equity rights to employees of a parent company are problematic. In addition, grants in brother–sister arrangements pose difficulties.

### **Stock Valuation**

The Final Regulations include a number of provisions relating to stock valuation:

## ***Consistency***

Stock options or stock appreciation rights issued with a strike price equal to the fair market value of the underlying stock on the grant date will be exempt from section 409A (if granted with respect to service recipient stock). Under the Final Regulations, one valuation method may be used to determine such strike price, and another method may be used to determine the fair market value of the underlying stock on the payment date. Consistency between methods is not required, provided each valuation method used is itself consistently applied and otherwise satisfies the requirements of the Final Regulations.

## ***Stock Readily Tradable on an Established Securities Market***

To determine the value of stock that is readily tradable on an established securities market, the Final Regulations require that the valuation be determined on the basis of one of the following market measures: (1) the last sale before or the first sale after the grant, (2) the closing price on the trading day before or the trading day of the grant, (3) the arithmetic mean of the high and low prices on the trading day before or the trading day of the grant, or (4) any other reasonable basis using actual transactions in the stock in the applicable market. The fair market value may also be determined based on an average selling price over a specific period within 30 days before or after the grant date, provided that the commitment to grant the stock right on a particular day is irrevocable prior to the start of the measurement period. To satisfy this requirement, the service recipient must designate the recipient of the stock right, the number of shares subject to that right, and the method for determining the strike price, including the period over which the averaging will occur, prior to the beginning of the measurement period. A limited exception exists to the extent that another averaging requirement must be used under applicable foreign law.

## ***Stock Not Readily Tradable on an Established Securities Market***

The Final Regulations require that a reasonable application of a reasonable valuation must be used to determine the fair market value of stock that is not readily tradable on an established securities market. Any of the following alternative valuation methods will be presumed to result in a reasonable valuation, unless the IRS can establish that the use of such method was grossly unreasonable:

- A valuation determined by an independent appraiser that meets certain prescribed statutory standards under the Code and applicable Treasury Regulations, provided the appraised value is as of a date no more than 12 months prior to the relevant grant date;
- A valuation based on the tax principles governing the valuation of shares subject to nonlapse restrictions, provided the method governs the subsequent transfer of any shares subject to those nonlapse restrictions (or any substantially similar class of stock) to the issuer or any person possessing more than 10% of the total combined voting power of all classes of stock of the issuer, other than an arm's-length transaction involving the sale of all or substantially all of the issuer's outstanding stock; or
- For an illiquid stock not subject to any nonlapse put or call right or obligation (other than a first refusal right) and issued by a startup corporation that has not conducted a trade or business for a period of 10 years or more, a written valuation report that takes into account the value of the tangible and intangible assets of that corporation, the present value of its anticipated future cash flows, the market value of stock or equity interests in similar corporations and other entities engaged in substantially the same business, recent arm's-length transactions involving the sale

or transfer of such stock or equity interests, and other relevant factors such as control premiums or discounts for lack of marketability. The report need not be done by an appraisal firm; however, such valuation must be conducted by an individual with sufficient knowledge, experience, and skill in valuing illiquid stock of a startup corporation. In general, an individual with at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the corporation operates will be deemed to possess sufficient knowledge, skill, and training to perform the valuation. However, this valuation method will not be deemed reasonable if, at the time it is performed, it is anticipated that the corporation will undergo a change in control within the next 90 days or commence an initial public offering within the next 180 days.

### **Modifications of a Stock Right**

Certain types of modifications to an existing stock option or stock appreciation right will, for purposes of section 409A, be treated as a new grant that will be subject to section 409. The modification will have such effect if the modification results in a direct or indirect reduction of the strike price of the stock right, an additional deferral feature, or an impermissible extension of the term of the stock option or stock appreciation right.

The following changes to an existing stock option or stock appreciation right will not be treated as a modification for purposes of section 409A:

- A reduction in the term of a stock option or stock appreciation right;
- The addition of a right to tender previously acquired stock to pay the strike price; or
- The addition of stock withholding rights to facilitate the payment of the strike price or the employment or withholding taxes resulting from the exercise of the stock option or stock appreciation right.

The extension of the period for which a stock option or stock appreciation right remains exercisable may trigger the application of section 409A retroactively to the original grant date. However, in a significant liberalization from the proposed regulations, the term of a stock option or stock appreciation right that would otherwise be shortened due to separation from service or another event may be extended to the *earlier* of the original maximum term of the stock right or 10 years from the original grant date without triggering section 409A. In addition, if the stock right is underwater at the time of the extension, the exercise term may be extended to any date without subjecting the stock right to section 409A. Finally, an extension granted prior to April 10, 2007 solely to give the holder an additional period of time to exercise the stock right is disregarded and is not treated as an additional deferral feature.

### **Tandem Rights**

A stock right can be structured as a tandem arrangement under which the exercise of one right terminates the other right (e.g., a stock option and a stock appreciation right, exercisable on an alternative basis) or as a substitution of a stock appreciation right for a stock option identical in all respects to the stock option except for the medium of payment, each without subjecting the arrangement to coverage under section 409A.

## **Transition Rules**

The Final Regulations include the following transition rules applicable to stock rights:

### ***Determination of Fair Market Value***

For stock rights issued before January 1, 2005, the strike price will be treated as having been set at not less than fair market value in compliance with section 409A, if the price was established based on a good-faith attempt by the issuer to set such strike price at or above fair market value. For stock rights issued on or after January 1, 2005, but before January 1, 2008, the determination as to whether the strike price is equal to the fair market value on the grant date may be made using a reasonable valuation method, as described in IRS Notice 2005-1, or a methodology described in the proposed or Final Regulations.

### ***Service Recipient Stock***

If a stock right is issued before April 10, 2007 on stock that would have constituted service recipient stock under a reasonable good-faith interpretation of section 409A and the applicable guidance, but would not constitute service recipient stock under the Final Regulations, such stock will continue to constitute service recipient stock for purposes of section 409A until the exercise or termination of that right or until that right is modified in a manner that is treated as a new grant. For a stock right that is issued on or after April 10, 2007, stock subject to such right will not be treated as service recipient stock after December 31, 2007, unless such stock satisfies the requirements of the Final Regulations.

### ***Modifications and Extensions of Stock Rights***

The Final Regulations expand the permissible types of modifications and extensions of stock rights, and taxpayers may rely on the Final Regulations before the January 1, 2008 effective date. In addition, any modifications or extensions to a stock right that occurred before October 23, 2004 are disregarded for purposes of determining whether the right is subject to section 409A. Finally, any extension granted before April 10, 2007, solely in order to give the holder of a stock right an additional period of time within which to exercise the stock right beyond the original termination date, is disregarded for purposes of the rules treating certain extensions as deferral features subject to section 409A.

A great deal of planning opportunity exists with respect to the above transaction rules, but the transition period expires at the end of the 2007 calendar year.

If you have any questions or would like further information on the Final Regulations under section 409A, please contact any one of the following Morgan Lewis attorneys:

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