

Morgan Lewis

together

How the Section 409A Final Regulations Impact Equity Compensation Plans



Presented by:
S. James DiBernardo
Zaitun Poonja
Heather Brookfield

June 5 & 7, 2007

Introduction

- Final regulations retain the basic structure of the proposed regulations for stock rights
- Liberalization of limitations imposed under the proposed regulations
 - Nature of service recipient stock
 - Valuation standards for non-publicly traded stock
 - Extension of exercise period
- Preamble provides guidance as to the tax treatment of non-compliant stock rights

Exemption for Stock Options and Stock Appreciation Rights

- ISOs are exempt
- Section 423 purchase rights are exempt
- 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
 - 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 are eligible for the exemption even if the underlying stock is not traded on an established market or if settlement is to be made in cash rather than shares of stock

Exemption for Stock Options and Stock Appreciation Rights

- Equity awards which were earned and vested as of December 31, 2004 are not subject to Code Section 409A unless the plan or arrangement under which those amounts were deferred is materially modified after October 3, 2004
- Equity awards that were not vested as of December 31, 2004 are subject to Section 409A

Stock of Service Recipient

- Eligible Classes of Stock
 - Must be common stock of the service recipient
 - Any class of common stock may be used
 - Does not matter if the stock is not publicly traded and there is another class of service recipient stock that is publicly traded
 - Does not matter whether the common stock has the highest aggregate value outstanding
 - Stock cannot be subject to any preferences as to dividends, 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

- Permissible Service Recipient
 - Direct recipient of services
 - 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%
 - Stock of subsidiary of service recipient is not service recipient stock

Stock of Service Recipient

- Permissible Service Recipient (continued)
 - 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
 - Any ownership structure undertaken to solely provide deferred compensation not subject to Section 409A will be disregarded
 - Stock rights issued prior to April 10, 2007 do not need to be modified if issued as service recipient stock under transition guidance

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 specific 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 the identity of the recipient, the averaging period based on such value must be irrevocable before the start of the averaging period
 - Permissible to use up to 30 day average if required by foreign law

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 IRS 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
 - 5 years of relevant experience is considered significant experience
 - However, this valuation method will not be permissible if a change in control is reasonably anticipated within the next 90 days or initial public offering of the stock is reasonably anticipated to occur within the next 180 days

Determination of Fair Market Value

- Consistency not required – can use different methods for different purposes e.g. to determine exercise price and to determine repurchase price
- If stock becomes readily tradable on an established market before exercise or payment, the valuation method for readily tradable stock must be used
- Stock rights issue prior to January 1, 2008 with exercise prices that meet fair market value rules under transition guidance do not have to be repriced if the valuation does not meet final regulations

Modification

- Certain modifications to an existing award will be treated as a new grant which will be subject to Section 409A
 - Direct or indirect reduction of the strike price
 - Addition of a deferral feature
 - Extension of the term of the stock option or SAR
- The following changes to an existing option or SAR will NOT be treated as a modification for purposes of Section 409A:
 - Reduction in the term of the option or SAR
 - Addition of a right to tender previously acquired stock to pay the strike price
 - Addition of stock withholding rights to facilitate payment of the strike price or withholding taxes

Modification

- The term of a stock option or SAR that would otherwise be shortened due to the holder's 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
- If the stock option or SAR 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

Modification

- An extension granted prior to April 10, 2007 solely to give the holder an additional period of time to exercise is disregarded for purposes of determining whether the right is subject to Section 409A
- Modifications and extensions to a stock right that occurred prior to October 23, 2004 are disregarded for purposes of determining whether the right is subject to Section 409A
- A corporation may substitute a new option for an outstanding option or assume an old option in a corporate transaction without violating 409A if the requirements of Section 424 (relating to ISO's) are met

Assumption

- A corporation may substitute a new option for an outstanding option or assume an old option in a corporate transaction without violating 409A if the requirements of Section 424 (relating to ISO's) are met
 - The ratio of the exercise price to the fair market value of the shares subject to the new or assumed option cannot be more favorable than the same ratio for the old option
 - The spread on the new or assumed must not exceed the spread on the old option
 - Flexible rules for determining fair market value based on averages
- The corporation assuming or substituting is not required to be the optionee's employer

Restricted Stock and RSUs

- Restricted Stock
 - Not subject to Code Section 409A, whether or not Section 83(b) election is made
 - Not as flexible a tax planning vehicle as Restricted Stock Units

Restricted Stock and RSU's

- Restricted Stock Units
 - Not subject to Code Section 409A if the shares underlying the units are issued at the time of vesting or by March 15 of the year following the vesting event
 - Retirement vesting provisions may inadvertently create a deferred compensation arrangement subject to Code Section 409A
 - Restricted Stock Units subject to Code Section 409A will comply with the statute if the grant provides for issuance of the underlying shares upon one or more of the permissible Code Section 409A events, for example, separation from service, change in control, or specific date
 - Change in control definition must comply with Code Section 409A standards

Restricted Stock and RSUs

- If recipient is to be given individual deferral election:
 - Election must be made within 30 days after the award date
 - No vesting may occur within 12 months after the date of the election
 - Provision for automatic vesting acceleration upon death, disability or change in control does not per se violate 12-month deferred vesting rule, but such acceleration within the 12-month period may void election

Restricted Stock and RSU's

- Restricted Stock Units Subject to 409A—for example Restricted Stock Units vesting over 4 years but issuance of vested shares deferred until earlier of completion of vesting schedule or separation from service
 - May trigger 6-month holdback.
 - May need to structure dividend equivalent rights as separate arrangement to allow earlier distribution

Dividend Equivalent Rights

- If accumulated amounts attributable to dividend equivalent 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
 - Terms can be in the same or a separate document

Remedial Action For Non-Compliant Stock Rights

- Remedial action must be taken before the earlier of December 31, 2007 or the exercise of the non-compliant stock right
- Remedial Action I: Cancellation and Regrant
 - The new exercise price does not have to be the current market price of the underlying stock, only the market price on the date the option was originally granted
 - Cash bonus or Restricted Stock Unit award to compensate for the increased exercise price is permissible, provided no payment or vesting occurs in 2007

Remedial Action For Non-Complying Stock Rights

- Remedial Action II: Exercise Schedule
 - Specific calendar years are designated as years of exercise, with a designated number of shares allocated to each such year
 - If option is not exercised for the designated number of shares by the end of the applicable year, the option terminates with respect to those shares
 - Possible automatic exercise at year-end if option is in the money
 - Accelerated exercise possible upon separation from service or change in control after 2007 calendar year
 - Alternative not available if non-compliant stock rights exercised in 2006 or 2007

Exercise of Non-Compliant Options

- Assume non-compliant option for 3,000 shares with an exercise price of \$10 per share and vesting in 3 equal annual installments on March 31 of 2005, 2006 and 2007
- Option exercised for all 3,000 shares on May 31, 2007 when fair market value is \$25 per share
- 20% penalty tax payable for 2007 taxable year in the amount of \$9,000 ($3,000 \times (\$25 - \$10) \times .2$)

Exercise of Non-Compliant Options

- Interest penalty payable with 2007 taxes
 - Penalty attributable to 2005: compute hypothetical tax at 35% tax rate on 2005 year-end option spread on the 1,000 shares that vested in 2005
 - If fair market value per share is \$15 at year end, hypothetical tax is \$1,750 ($1,000 \times (\$15 - \$10) \times .35$)
 - Underpayment interest rate plus 1% accrues from April 15, 2006 to tax payment date for 2007 taxes

Exercise of Non-Compliant Option

- Interest Penalty attributable to 2006:
 - First, compute hypothetical tax at 35% tax rate on 2006 year-end option spread on the 1,000 shares that vested in 2006
 - If fair market value per share is \$20 at year end, hypothetical tax is \$3,500 ($1,000 \times (\$20 - \$10) \times .35$)
 - Underpayment interest rate plus 1% accrues from April 15, 2007 to tax payment date for 2007 taxes
 - Then compute hypothetical tax at 35% tax rate on any 2006 year-end appreciation on the 1,000 shares that vested in 2005
 - If fair market value per share is \$20 at year end, hypothetical tax is \$1,750 ($1,000 \times (\$20 - \$15) \times .35$)
 - Underpayment interest rate plus 1% accrues from April 15, 2007 to tax payment date for 2007 taxes

Timing Deadlines

- All plans and arrangements providing deferred compensation must be amended to comply with Section 409A by December 31, 2007
 - Inventory arrangements and consider design alternatives to bring arrangements into compliance with 409A
- Final regulations are effective January 1, 2008 but may be relied upon in the interim
- Employers may also rely on the proposed regulations, IRS Notices and good faith interpretations of the statute before January 1, 2008

Presenters



- **Heather Brookfield**
 - **415.442.1023**
 - **hbrookfield@morganlewis.com**



- **Jim DiBernardo**
 - **650.843.7560**
 - **jdibernardo@morganlewis.com**



- **Zaitun Poonja**
 - **650.843.7540**
 - **zpoonja@morganlewis.com**

Disclaimer

This communication is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship.