

Compensation & Employee Benefits Practice – Stock Options and Other Equity Awards Under Section 409A of the Internal Revenue Code

This is the third in a series of e-Alerts that the Compensation and Employee Benefits Practice Group of Troutman Sanders LLP is issuing on Code Section 409A. Please refer to our earlier e-Alerts which are posted on our website for a general overview of Code Section 409A and a more specific analysis of the rules regarding separation pay.

Stock options and stock appreciation rights with exercise prices less than the fair market value of the underlying stock at the date of grant (with certain exceptions), and restricted stock and other equity awards that are not paid shortly after vesting, need to be brought into compliance with Code Section 409A by December 31, 2007. Exercises of such options and rights, and payments of such other rights, before January 1, 2008 could result in a violation of Code Section 409A.

Section 409A of the Internal Revenue Code, as amended (the “Code”), imposes significant requirements on “deferred compensation.” As noted in our first e-Alert dated May 5, 2007, deferred compensation under Code Section 409A includes certain types of equity-based compensation arrangements that are not usually thought of as deferred compensation, if no exemption is applicable.

Companies should review their equity plans and outstanding awards to determine whether and the extent to which Code Section 409A applies. Although the new tax regime generally became effective as of January 1, 2005, the written document that sets forth the award must comply in form with Code Section 409A by December 31, 2007. To the extent any stock options or other equity awards have been modified, repurchased, exercised or terminated after October 3, 2004, they should be reviewed by the company for operational compliance with Code Section 409A. If not compliant, the correction could not only be very complex but also costly for the affected service provider (e.g., employee, director or independent contractor). Failure to comply with Code Section 409A may result in the service provider including the “deferred compensation” in income at the time it vests (and periodically thereafter) and being assessed a 20 percent tax in addition to normal income taxes.

A. Equity Awards Not Subject to Code Section 409A

Many typical equity arrangements are not subject to Code Section 409A because of a number of available exemptions. Incentive stock options and purchase rights under qualified employee stock purchase plans are exempt from Code Section 409A (absent no impermissible modification). Restricted stock awards generally are exempt from Code Section 409A provided the service provider does not elect to defer receipt and taxation of the stock later than the time it vests. Stock options and SARs that were granted before October 4, 2004 and fully

vested by December 31, 2004 (unless materially modified) are exempt from Code Section 409A under a special grandfather rule.

Non-qualified stock options and stock appreciation rights (“SARs”) are not subject to Code Section 409A provided (i) the exercise price is no less than the fair market value of the underlying stock on the date of grant, (ii) the number of shares subject to the option or SAR is fixed on the date of grant, (iii) the option or SAR covers “service recipient stock,” and (iv) the option or SAR does not include any deferral feature. Exempt SARs cannot give the holder compensation that is greater than the excess of the fair market value of the underlying stock on the date of exercise over the exercise price.

- To be exempt from Code Section 409A, non-qualified options or SARs must be granted with respect to “service recipient stock,” which generally means any common stock of an “eligible issuer of service recipient stock.” An eligible issuer of service recipient stock means (i) the corporation (if the entity receiving the services is a corporation) for which the service provider provides direct services and with respect to whom the right to the compensation arises and (ii) any corporation in a chain of corporations or other entities in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, ending with the corporation or other entity that has a controlling interest in the corporation or other entity for whom the services are being provided on the date of grant of the option or SAR. For this purpose, a controlling interest generally means 50 percent or more, although a controlling interest may be as low as 20 percent if a legitimate business reason exists for using the lower threshold. An eligible issuer of service recipient stock is not the same as the service recipient. The service recipient generally means the person for whom the services are performed and with respect to whom the legally binding right to the compensation arises (and all related entities within the same controlled group of corporations or under common control with the service recipient).
- The common stock for purposes of this exemption does not include any class of stock that has any preferences as to distributions other than distributions of service recipient stock and distributions in liquidation of the issuer of the stock.
- Common stock is not “service recipient stock” if it is subject to a mandatory repurchase obligation (other than a right of first refusal), or a permanent put or call right, at other than fair market value.
- Code Section 409A also imposes certain valuation requirements to determine the fair market value of the underlying stock for purposes of the exemption. If the stock is publicly traded, the value may be the closing price or an average price on the trading date before or on the date of grant, so long as the method is consistently applied. The value can also be based on an average selling price that covers a specified period within 30 days before or after the date of grant, provided the commitment to grant the award is irrevocable and the valuation method is consistently applied and fixed in advance.
- For stock that is not publicly traded, any reasonable valuation may be used as long as it is consistently applied. A reasonable valuation should address (i) the value of tangible and intangible assets of the corporation, (ii) the present value of anticipated future cash flows, (iii) the market value of the stock, (iv) the value of other entities engaged in similar trades or business, (v) recent arms length transactions involving the stock, and (vi) other relevant factors such as control premiums and discounts for lack of marketability. The valuation method is not reasonable if it does not take into account all available material information. For purposes of the exemption, the valuation cannot be as of a date that is more than 12 months earlier than the date of grant of the award. There also are “safe harbor” valuation methods for certain independent appraisals (including ESOP valuations), formula valuations and start-up companies. These safe harbor methods are presumed to result in a reasonable valuation that can only be rebutted by a showing that the valuation method was grossly unreasonable.
- Any right that allows a recipient to elect to defer payment to a time later than the exercise of the right or the time the stock acquired would become vested likely would constitute a prohibited deferral feature.
- Special attention should be given to any right to receive dividends on the shares underlying the stock right. To the extent the right to receive the dividends is, directly or indirectly, contingent upon the exercise of the right, the stock option or SAR will not be exempt. If the right to dividends is not contingent upon, or otherwise payable on, exercise of the right, the dividend rights should not cause the option or SAR to fail to be exempt, although the dividend right is potentially a separate deferred compensation arrangement.

- The exemption should apply to tandem rights where all the terms except the mode of payment, i.e., cash or stock, are the same.
- Until further guidance is issued, taxpayers may apply these same principles to equivalent rights in partnership interests.

B. Equity Awards Subject to Code Section 409A

The most significant exemption available for equity awards that do not qualify for the exemption described above for options and SARs is the “short term deferral rule.” This rule exempts payments from Code Section 409A provided they are to be made by the 15th day of the third month following the end of the year in which the right to the payments vest (either the year of the service recipient or of the service provider, whichever is later).

Accordingly, discounted options or SARs or options or SARs covering stock that does not qualify as “service recipient stock” generally are subject to Code Section 409A where the option or SAR can be exercised later than the 15th day of the third month following the end of the year in which the right to exercise the option or SAR vests. Restricted stock units, performance awards and other incentive awards also are subject to Code Section 409A, unless they qualify under one or more of the other exemptions under Code Section 409A, such as the short-term deferral rule described above.

Moreover, exempt options and SARs may become subject to Code Section 409A if they are impermissibly modified or the period for exercise of the option or SAR is extended. Options and SARs that are vested as of December 31, 2004 and grandfathered also remain so only as long as they are not materially modified. Options and SARs generally are deemed vested if there is no substantial risk of forfeiture or any requirement to perform future services. As a general rule, a noncompete restriction is not considered a substantial risk of forfeiture for purposes of Code Section 409A. However, options or SARs that are subject to a noncompete restriction will not be considered vested for purposes of the grandfather rule.

Before January 1, 2008, discounted options and SARs that are not grandfathered may be replaced with fair market value options or SARs provided cancellation and reissuance does not include the payment in 2007 of cash or other vested property to the holder of the replaced option or SAR. This transitional rule does not apply to options or SARs granted by a public company to a director, officer or principal shareholder to the extent the compensation expense related to the discounted option or SAR was not timely reported according to generally accepted accounting principles.

An option that is exempt from Code Section 409A may become subject to Code Section 409A if it is modified, because the modification may be treated as the grant of a new award. The term “modification” generally includes any change in the terms of the option or SAR that provides the holder with (i) a direct or indirect reduction in the exercise price, (ii) an additional deferral feature, or (iii) an extension or renewal of the right, regardless of whether the holder in fact benefits from the change in such terms. An extension includes not only an extension of the option or SAR but also conversion of the right into a payment of compensation in the future. When the term of an option or SAR is extended, it is treated as having an additional deferral feature and, thus, subject to Code Section 409A from the original date of the grant, unless the option is extended to no later than the earlier of the original maximum term of the award determined without regard to any early termination feature or 10 years from the date of grant. Extensions that are not later than the earlier of the original maximum term of the award or such 10 years will not be treated as the grant of a new award. Certain modifications will not disqualify the option’s or the SAR’s

exempt status, such as (i) accelerating vesting of the award, (ii) allowing the stock right to be transferred, (iii) permitting payment of the exercise price through previously-owned shares, (iv) changing the way required withholdings are paid, (v) extending underwater options or SARs (which will be treated as a new right) or (vi) if the right is tolled while the holder cannot exercise it in certain circumstances. For example, there is not a prohibited extension of an option or SAR if the expiration of the option or SAR is tolled while the holder cannot exercise the right because the exercise would violate federal, state, local or foreign law, or jeopardize the ability of the company to continue as a going concern, provided that the period during which the option or SAR could be exercised is not extended more than 30 days after the exercise of the option or SAR first would no longer violate an applicable federal, state, local or foreign law or jeopardize the ability of the company to continue as a going concern.

There also is an exemption for modifying options or SARs in connection with corporate reorganizations or transactions so long as certain ratio and spread tests are satisfied. For Code Section 409A purposes, if the aggregate spread of the new stock right does not exceed the aggregate spread of the old stock right and the ratio of the exercise price to the fair market value of the shares subject to the right immediately after the substitution is not greater than the ratio of the exercise price to the fair market value of the shares subject to the right immediately before the substitution, then the substituted stock right will not be treated as a grant of a new option or SAR for Code Section 409 purposes.

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