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Application of Section 409A to Private Company Stock Options and Other Equity Awards

On October 4, 2005, the Internal Revenue Service (referred to in this Alert as the "IRS") issued proposed regulations for Section 409A of the Internal Revenue Code (referred to as "Section 409A" in this Alert). The proposed regulations are intended to further explain how Section 409A applies to various compensatory arrangements, including stock options granted by private companies. This Alert discusses in a question and answer format the effect of the proposed regulations on private company stock options.

Does Section 409A apply to private company stock options?

Section 409A is written so broadly that it applies to all equity compensation. However, the IRS has provided guidance to limit its application. Nonqualified stock options are exempt from Section 409A if the following requirements are met:

- the option is granted with an exercise price per share equal to or greater than the grant date fair market value per share of the common stock subject to the option and at no point through the exercise date of the option is the exercise price below the grant date fair market value;
- the number of shares subject to the option must be fixed on the grant date of the option; and
- the option may not include any additional feature for the deferral of compensation (other than deferral of recognition of income until the award is exercised or vested). (Note, standard option grants generally do not include any additional deferral features.)

This Alert discusses in a question and answer format the effect of the proposed regulations on private company stock options.

Are incentive stock options subject to Section 409A?

No. The proposed regulations state that incentive stock options are exempt from Section 409A. This exemption does not apply if an amendment disqualifies the incentive stock option.

Are any nonqualified stock options grandfathered from Section 409A?

Yes. Stock options are grandfathered from Section 409A if the option was vested before January 1, 2005. The exemption will end if the stock option is materially modified after October 3, 2004.

What type of stock may be used for options that are exempt from Section 409A?

Under the proposed regulations, only options granted for common stock of the “service recipient” (see next question and answer) will be exempt from Section 409A. Options for preferred stock will not qualify and will be subject to Section 409A, even if they are granted with an exercise price equal to the fair market value of the preferred stock. For private companies, common stock means the class of common stock having the greatest aggregate value outstanding. A class of common stock with substantially similar rights to such class, except for any differences in voting rights, will also qualify as common stock under Section 409A. Stock will not qualify as common stock under Section 409A if it has a preference as to liquidation or dividend rights (such as preferred stock), or has certain mandatory repurchase obligations or put or call features that are based on a measure other than fair market value (except where such mandatory repurchase obligations and put and call features lapse over time, such as a repurchase right for unvested stock).

Which company qualifies as the “service recipient” that can issue the exempt options?

The term “service recipient” is generally defined in the proposed regulations to mean the company for whom the services are performed, as well as subsidiary members of that company’s controlled group. (A controlled group consists of a parent company and its 80% or more owned subsidiaries). The proposed regulations permit a company to elect that the 80% threshold be reduced to 50%, or, if the use of such stock is based upon legitimate business criteria (such as to compensate employees of a joint venture in which the company issuing the options owns 20% of the joint venture), that the 80% threshold be reduced to 20%. The choice of threshold percentage must be used consistently.

What companies qualify as private companies under Section 409A?

Under the proposed regulations, what we refer to as a “private company” is defined as a company whose common stock is not “readily tradable on an established securities market.” The regulations go on to state that an established securities market is either (i) a national stock exchange registered with the U.S. Securities and Exchange Commission, (ii) a foreign national securities exchange which is officially recognized in such foreign country or (iii) any over-the-counter market. From this definition, it would appear that any company whose stock is publicly traded, whether in the United States or internationally and whether on the New York Stock Exchange or on an “over-the-counter” market, will not be a “private company” for purposes of Section 409A.

As a private company, how do we determine the fair market value of our common stock for purposes of these rules?

The proposed regulations state that for the IRS to accept a valuation of private company common stock, it must be done by “the reasonable application of any reasonable valuation method.” Factors that the IRS states should be considered in the valuation in order for the valuation method to be reasonable include:

- the value of 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 and other companies engaged in trades or businesses substantially similar to those engaged in by the corporation being valued, the value of which can be determined by objective means (such as through trading prices on an established market or an amount paid in an arms length private transaction); and
- other relevant factors, such as 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 service recipient, its stockholders or its creditors.

The value must be determined taking into consideration all available information material to the value of the corporation, and must be calculated as of a date that is within 12 months of the date for which the valuation is being used.

Are there any valuation methods that will be presumed to be reasonable?

Yes. While the foregoing “facts and circumstances” standard raises uncertainty, the proposed regulations provide three specific methods that the IRS will presume to be reasonable if consistently applied: (1) an appraisal by an independent appraiser as of a date that is within 12 months of the date for which the value is being determined; (2) a valuation of illiquid stock of a start up company by experienced personnel and (3) a valuation based upon certain types of formulas.

What is the “start up” valuation method?

To qualify as “illiquid stock” of a “start-up” company under the proposed regulations, the following requirements must be met:

- the valuation must be made reasonably and in good faith and be evidenced by a written report that takes into account the relevant valuation factors described above;
- the company (and its predecessors) cannot have been in the active conduct of a business for ten years or more;
- the company cannot be public (i.e., it cannot have any securities that are readily traded on an established securities market);
- there must not be any permanent put or call on the stock or any permanent requirement that the company or any other person purchase the stock (a right of first refusal or a repurchase right for unvested restricted stock awards is permitted); and
- at the time of the valuation, it cannot reasonably be anticipated that the company will undergo a change in control or an initial public offering within 12 months after the valuation.

The person(s) performing the valuation of a “start-up” company must have significant knowledge and experience or training in performing similar valuations.

They may be employees or directors of the company. In many instances, it would appear that a board of directors or a committee of the board of directors of the start up company may do the valuation, where the board or committee is composed of experienced venture capitalists or private equity investors that have significant experience in valuing start up companies.

What is the “formula-based” valuation method?

A formula-based valuation also will be presumed to be a reasonable valuation method if certain requirements are met. Examples of the formula-based valuation method would be valuing the stock based on a multiple of sales or earnings, or book value. However, for a formula-based valuation to qualify under the proposed regulations, it must be consistently applied to all valuations of the stock. For example, the formula value would have to be used for issuances to and repurchases by the company from third parties and non-employees as well as for regulatory filings and loan covenants. This appears to be a very restrictive method and we do not anticipate many companies will be willing and able to qualify for this method.

How long will a valuation be valid?

All valuations under any of these methods are valid until the earlier of (i) 12 months from the valuation date or (ii) a material change in the value of the company. Any method used must be applied consistently for all valuations.

How do these rules apply to stock options granted before January 1, 2005?

In the proposed regulations, Section 409A applies to all stock options that were not vested prior to January 1, 2005. No distinction is made based on the grant date of the option. However, on December 23, 2005, the IRS published supplemental guidance to address concerns companies had with retroactively applying the proposed regulations to nonstatutory stock options granted prior to January 1, 2005. In this supplemental guidance, the IRS will deem stock options to be granted at fair market value if there was a good faith attempt to set the exercise price of the stock option at fair market value. This is the same standard that is used for incentive stock options and should alleviate some of the burden and concern about ensuring that stock options granted in the past few years will comply with Section 409A. Unfortunately, the supplemental guidance provides that this standard will only apply until further guidance is issued by the IRS, so it is possible that the IRS will issue final guidance on this matter that is not as favorable.

What happens if we amend an outstanding option?

It depends on the amendment. An amendment may cause the option to be subject to Section 409A if it is considered a “modification” of the option.

A “modification” means any change in the terms of a stock option (or the plan or arrangement pursuant to which it is granted) that provides the optionholder with a direct or indirect reduction in the exercise price of the stock or an additional deferral feature, or an extension or renewal of the stock option (whether or not the optionholder benefits from the change).

Plan or award amendments that do not meet these criteria would not be treated as modifications under Section 409A. The proposed regulations specifically state that amendments to shorten the exercise period, permit payment of the exercise price with existing shares, or to withhold shares to facilitate payment of employment or withholding taxes, will not be treated as modifications. Also, the exercise of reserved discretion with respect to the transferability of a stock option will not be treated as a modification.

The proposed regulations provide that any modification of the terms of a stock option, other than an extension of the term or a renewal of the stock option, is considered the granting of a new stock option on the date of the amendment. As a result, when a stock option is modified (other than to extend or renew the stock option), it will be subject to Section 409A unless the exercise price for the option is not less than the fair market value of the underlying stock on the date of the modification (assuming the other requirements for exemption from Section 409A are still satisfied).

What happens if we extend the term of an outstanding stock option?

The extension of the term of an option will result in the option being treated as having an additional deferral feature as of the date of initial grant, and therefore not being exempt from Section 409A. (Note, this would seem to be the case even if the exercise price was greater than the fair market value of the stock on the date the term was extended.) Extensions or renewals (other than short-term extensions and extensions to comply with securities laws) would result in the options failing to satisfy the requirements of Section 409A unless the option qualifies for some other exemption (such as the short-term deferral exemption) or is drafted to comply with Section 409A.

The proposed regulations provide an exception for "short term extensions," which are defined as extensions of the option that end before the later of (i) the end of the calendar year in which the option otherwise would expire, and (ii) the 15th day of the third month after the month in which the option otherwise would expire based upon the option terms on the original grant date. This should provide companies with some flexibility in extending the post-termination exercise period of an option, especially for terminations that otherwise would occur at the beginning of the calendar year.

In addition, a company may extend the exercise period (without violating the foregoing rule) if in the absence of the extension, the option could not have been exercised without violating securities laws (generally Section 16 of the Securities Exchange Act of 1934). The extension may be for up to thirty days after the option is first exercisable without violation of the securities laws.

Is a reduction in the exercise price of a stock option a modification?

Yes. As described above, a reduction of the exercise price of an option is treated as a new grant under the proposed regulations. If the new exercise price is at or above fair market value (and the other requirements for exemption are met), then the option will continue to be exempt from Section 409A. Only if the per share option exercise price is reduced below the fair market value of the common stock subject to

the option at the time of the amendment (or otherwise fails to satisfy the requirements for exemption) will the option become subject to Section 409A.

Are there any other rules relating to modifications?

The proposed regulations also set forth the following principles regarding modifications to stock options:

- the substitution of a new stock option pursuant to a corporate transaction for an outstanding stock option or the assumption of an outstanding stock option pursuant to a corporate transaction will not be treated as a modification if certain requirements are met;
- an acceleration of the date on which the stock option is exercisable or vested will not be treated as a modification;
- the addition of a discretionary additional benefit under a stock option will not be treated as a modification unless and until the additional benefit is granted;
- a change in the terms of the stock that is subject to a stock option that increases the value of the underlying stock is a modification (unless it is pursuant to a substitution of awards pursuant to a corporate transaction that is otherwise not treated as a modification);
- if a stock option is amended to increase the number of shares subject to a stock option (other than pursuant to certain stock splits, reverse stock splits, or stock dividends), the increase will be treated as a new grant with respect to the additional shares rather than a modification of the original stock option; and
- inadvertent changes to the terms of a stock option (or the plan pursuant to which the option is granted) will not be treated as modifications if they are rescinded by the earlier of the date the stock option is exercised or the last day of the calendar year during which the change occurred.

How do I fix stock options that do not qualify for an exemption from Section 409A to comply with the new rules?

There are several ways.

- One method would be to amend the option to comply with the requirements under Section 409A (see discussion below).
- If the option was granted with an exercise price below fair market value, it could be fixed by increasing its exercise price to the grant date fair market value. The preamble to the proposed regulations describes various ways in which companies that amend outstanding awards to increase the option exercise price may make up for the lost discount through the payment of cash, restricted stock, or other property.

- If the option had an additional deferral feature, the removal of the additional deferral feature may fix it.

The proposed regulations extend the time period for retroactively amending or replacing outstanding awards to comply with or be exempt from Section 409A until December 31, 2006.

What should we do to make sure that a stock option subject to Section 409A complies with Section 409A?

Applying Section 409A to an option will require amending the option to fix the times when the stock may be distributed to the optionholder (and when the option may be cashed out.) The stock or cash to be paid to the optionholder for the option may be paid on account of death, disability, separation from service, an unforeseen emergency, or a change in control, or at a specified time (or schedule of specified times). Neither the employer nor the optionholder may have the ability to accelerate the time when payment is to be made (and there are very restrictive requirements for delaying the payment past the specified dates, as well). These general principles are more fully described in another Alert prepared by our firm. The requirements would be satisfied, however, if, for example, the stock option was automatically exercised at a time that complied with the requirements of Section 409A (e.g., on the earliest of separation from service, a change in control, or 5 years after the date of grant) or the stock or cash received upon exercise of the stock option was automatically distributable on a date that complied with the requirements of Section 409A (regardless of when the option was exercised).

Does Section 409A apply with respect to stock appreciation rights?

Yes, it may. Under the IRS' earlier guidance (Notice 2005-1), stock appreciation rights granted for shares of a private company were subject to Section 409A regardless of the strike price. However, in the proposed regulations, as a result of the comments received, the IRS reversed its position in the Notice and provided that all stock appreciation rights will be exempt from Section 409A if they are granted with a strike price that is at least equal to the grant date fair market value of the common stock subject to the right. As a result, the rules for stock appreciation rights under Section 409A are the same as for stock options.

Does Section 409A apply with respect to grants of restricted stock?

Generally, no. The proposed regulations make it clear (as did Notice 2005-1) that restricted stock is exempt from Section 409A. However, restricted stock would be subject to Section 409A if it provided for a deferral feature (i.e., a provision that enabled the recipient to defer recognition of income beyond the date on which the restricted stock vested).

Does Section 409A apply with respect to restricted stock units and phantom stock arrangements?

Generally, yes. Unless the arrangement qualifies for an exemption, these arrangements generally will be subject to Section 409A, including the rules relating to the timing of elections, the events upon which distributions may be based, and the prohibition against the acceleration of distributions. The simplest way to satisfy these

requirements would be to provide for benefits under these arrangements to be distributed automatically upon the occurrence of one or more specified events that are permitted under Section 409A (e.g., the earliest of separation from service, a change in control, or 5 years form the date of grant).

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